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The PB Report 2008

A Publication of the Privatization Barometer
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Reporting on privatization in the enlarged Europe

Against all odds

THE WEBSITE ON PRIVATIZATION IN EUROPE

Fondazione Eni Enrico Mattei
Fondazione IRI

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The PB Report

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What is the PB Report?

The PB Report is a twelve-month summary on privatization activity in the enlarged European Union. It aims at monitoring the most recent trends, at analyzing aggregate data on revenues and transactions, and at providing updated statistics at the country and sector level.

The report highlights the most important privatization deals of the year, focusing on the European Union but monitoring also the process around the rest of world and hosts contributed articles by top international scholars, who will make accessible to the reader the most recent results of professional research.

Rigorous, updated, easily accessible and freely distributed on the web, the PB Report is an authoritative source of information and a vehicle for a more informed discussion on the choices and consequences of privatization.

In 2008, Fondazione IRI, the main partner of Privatization Barometer, has been liquidated. Fondazione IRI provided the necessary funding for the design and implementation of the project. We gratefully acknowledge its contribution and warmly thank its President, Antonio Pedone for his insights and support throughout this venture.

Executive Summary

What a year! 2008 will be counted historic for many, mostly negative financial reasons, including the sharpest peacetime decline in economic activity and stock market valuation since the Great Depression and the largest ever single-year government purchases of private-sector financial stocks. In fact, 2008 was the first year since the Mitterand nationalizations of French corporations in 1981 that governments worldwide acquired more assets from the private sector - probably exceeding $1.5 trillion in bank stocks and loans - than they divested to investors through privatization programs. This figure is impressive, especially considering that global privatization revenues from 1977 to date are worth the same amount.

Despite this litany of bad economic news and re-encroaching state ownership during 2008, there was actually more privatization activity during the year than is generally realized. Globally, state sales of assets through share issues and direct sales substantially exceeded $100 billion for the fourth year in a row, and totaled a respectable $110.89 billion. While this total is less impressive in Euros (€77.19 billion), and even in dollar terms represents a significant drop from 2007's worldwide total proceeds of $138.0 billion, the fact that governments continued divesting assets even during a severe financial crisis suggests that the fundamental logic behind all privatization programs - that private owners manage business assets more effectively than public owners - continues to motivate global policy-making. This underlying ideological and policy continuity also suggest that we are likely to see a series of enormous share issue privatizations once markets and economies stabilize in a few years, when governments sell off the (hopefully rehabilitated) financial company stocks they acquired under duress during 2008 and 2009.

Last year's global pattern of privatization differed from previous years, and especially from 2007, in that China and Russia were almost completely quiescent. Whereas China raised more through large share issue privatizations alone during 2007 (€41.93 billion, $60.80 billion) than did all 26 members of the European Union through all public and private sales combined (€38.74 billion, $52.16 billion), there were only five large Chinese SIPs during 2008 and these yielded proceeds that were smaller (€8.82 billion, $13.57 billion) than the value of the single largest French privatization, the merger of Gaz de France with Suez (€15.30 billion, $21.60 billion), that created a new private company with only 35.7% residual state ownership. In fact, the largest non-EU privatization of 2008 came not from China, Russia, or India, but from Brazil - the "B" of the

"BRIC" countries - in the form of a massive seasoned equity offering of common and preferred shares of Companhia Vale do Rio Doce in August that raised €8.68 billion ($12.06 billion) in new capital for the firm.

On the other hand, 2008 mirrored at least one important privatization pattern observed during 2007 and immediately preceding years: France was by far the most active divestor of state assets in the European Union. The €20.74 billion ($29.28 billion) French total for the year represented almost two-fifths of the entire EU annual privatization total of €52.52 billion ($76.34 billion). Ironically, two separate but related transactions in July 2008 - the aforementioned merger of Gaz de France with Suez and the mandated near - simultaneous partial floatation via IPO of Suez Environment--accounted for almost all (€19.95 billion, $28.17 billion) of the French total for the year. The only other European country to rival France in terms of total privatization proceeds was Sweden, which raised €13.69 billion ($19.33billion) through two successful large private sales during the first half of 2008 - the sales of the state's holdings in the stock exchange OMX to Nasdaq in February and the sale by auction of Vin & Spirit AB to Pernod in March - and one early in 2H2008 (the sale of the property company Vasakronan to AP Fastigheter in July). Shortly thereafter, the collapse of stock market valuations worldwide forced the center-right Swedish government to indefinitely halt its ambitious two-year old privatization program.

Total privatization proceeds in the EU during 1H2008 fell to the lowest level for the semester (€19.67 billion, $30.68 billion) since 2005. Almost half (48%) of this total was accounted for by the two large Swedish sales described above (OMX and Vin & Spirit). Outside of Sweden, there were only three truly large (€1 billion+) EU privatizations. First, the German state North Rhine-Westphalia sold its residential property company LEG to Whitehall funds, which netted the state €3.40 billion ($4.9 billion). The second was the private sale of a 25.1% stake in the German chemicals, energy, and property group Evonik Industries to the private equity firm CVC Partners, which netted €2.40 billion ($3.70 billion). The final large EU deal of 1H2008 was also the only significant European SIP of the semester. This was the €1.80 billion ($2.79 billion) IPO of a 25% stake in EDP Renovávies, the Portuguese renewable energy company and Energias de Portugal subsidiary.

The second half of 2008 saw EU privatization revenues increase by two-thirds over 1H2008, reaching €32.85 billion ($45.67 billion). As noted above, the GDF Suez merger and the Suez Environment IPO yielded a combined total of €19.95 billion ($28.17 billion) and Sweden's Vasakronan sale brought in another €4.95 billion ($6.99 billion), so these three privatizations together accounted for over three-quarters of the EU 2H2008 total. Apart from these sales, there were two other 1 billion+ privatizations, one of which is laden with both irony and history: after years of trying, the Italian government finally divested its remaining 49.9% stake in Alitalia to a consortium of Italian industrialists for €1.05 billion ($1.56 billion). The final large EU divestment of 2H2008 was the awarding of a 35-year concession to manage the Port of Piraeus (Athens) to the Chinese company Cosco in exchange for a payment of €3.09 billion ($4.36 billion).

Outside of the EU, 2008 was a tale of two very different semesters. Although non-EU total proceeds during 1H2008 (€11.28 billion, $17.59 billion) were down sharply from previous periods, especially 2H2007, the majority of the semester's sale proceeds were accounted for by "the usual suspects." China raised €7.74 billion ($12.07 billion) through four large A-share IPOs between January and June, while Turkey raised €2.32 billion ($3.62 billion) through the trade sale of Tekel Cigarette and the long-delayed IPO of a 15% stake in Turk Telecom. No other non-EU government raised more than €500 million during 1H2008, though several had large planned sales well advanced in the preparatory stage before the market turmoil of second half market turmoil forced cancellations.

The second half of 2008 was more interesting than 1H2008 for non-EU governments, especially for Brazil and the United States. As noted above, Brazil's Vale do Rio Doce executed a massive primary share issue that raised €8.68 billion ($12.06 billion) in the largest SIP of 2008, while America executed the first large-scale divestment of a major Airport, Chicago's Midway, in a September transaction that raised €1.77 billion ($2.50 billion). The only other large non-EU privatization of 2H2008 was a direct sale of three Singaporean power plants to a Japanese utility in December, also for €1.77 billion ($2.50 billion).

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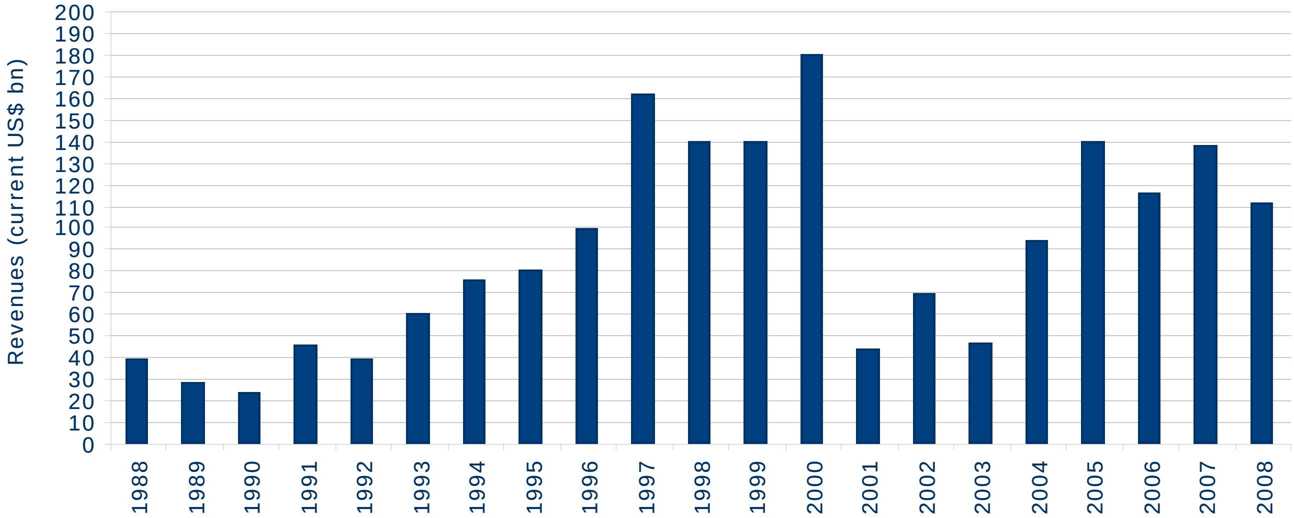
Privatization Trends and Major Deals in 2008

Global Trends in Privatization, 2008

Clearly, history will not remember 2008 as a year when governments were privatizing companies, but instead as the year when the state was forced to purchase corporate equity on a vast scale in order to prevent the collapse of western banking systems. Nonetheless, the year just passed witnessed several important and interesting state divestitures and 2008 will actually rank as a decent year for privatization in terms of total proceeds raised—at least as measured in dollars. State divestitures yielded $110.88 billion for governments, which as Figure 1 indicates, makes 2008 the eighth highest year for total proceeds ever. Even measured in Euros, 2008's total proceeds of €77.19 billion represents a better-than-average privatization year. Furthermore, European sales represented less than half of the global privatization total last year, so this value somewhat understates the macroeconomic significance of last year's divestments.

However measured, there were several significant privatization deals in Europe, Asia, and North and South America in 2008. For example, last year witnessed the largest ever Latin American share issue privatization—indeed, the largest share offering of any kind--the massive €8.68 billion ($12.06 billion) seasoned equity offering of common and preferred shares by Companhia Vale do Rio Doce. 2008 also saw the culmination of one long-running European merger battle that was effectively a privatization, the union between Gaz de France and Suez, as well the cancellation of another long-planned and hotly contested flagship privatization, the IPO of Deutsche Bahn. Additionally, the year just past saw the United States finally privatize a major airport (Chicago's Midway), but

Figure 1. Worldwide Revenues from Privatizations 1988 - 2008



Source: *Privatization Barometer*

also saw an even larger planned sale of the Pennsylvania Turnpike collapse due to political wrangling. This was an exciting year, with a mixed record overall.

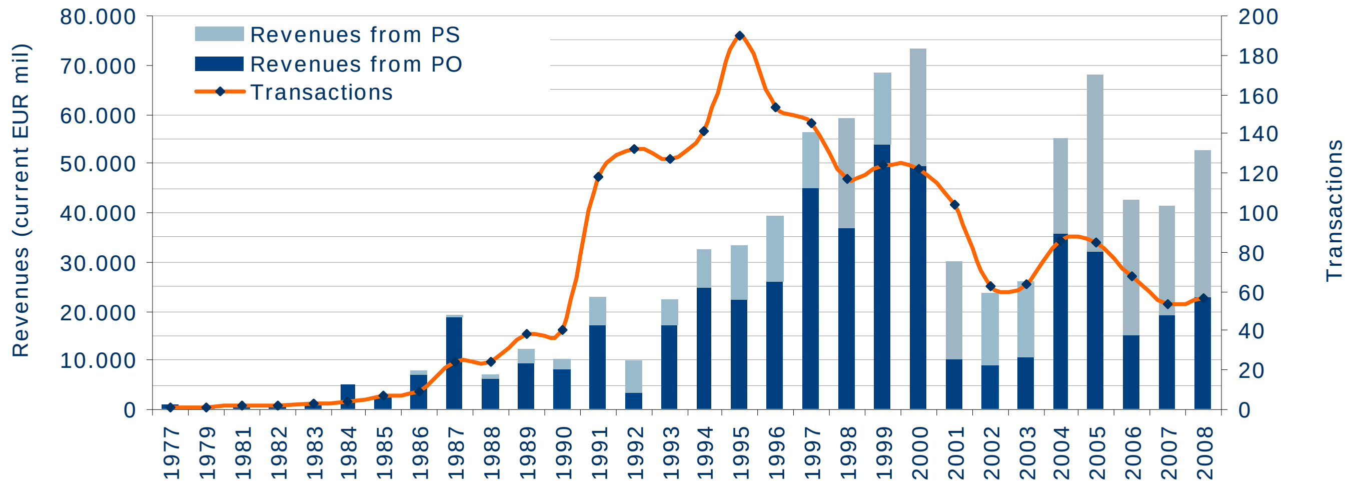
We argue that the worldwide total of privatization proceeds during 2008 was respectable, and this is also true for the European Union. As Figure 2 demonstrates, the €52.52 billion ($76.18 billion) EU governments raised last year actually makes 2008 the seventh best on record, and the best year since 2005. Furthermore, continuing a trend that emerged after 2000, EU governments raised more proceeds through private sales than through public offerings for the eighth year in a row. In fact, there were only two large (€1 billion+) European share issue privatizations (SIPs) during 2008, though the year's largest SIP—the Suez Environment IPO in July that raised €4.65 billion ($6.70 billion)—would be considered large by historic EU standards.

Figure 3 shows that France was by far the most active privatizer in the European Union, and its €20.74 billion ($29.28 billion) yield for the year represented almost two-fifths of the entire EU annual privatization total. The only other European country to rival France in terms of total privatization proceeds was Sweden, which raised €13.69 billion ($19.33billion) through three large private sales during the first eight months of 2008. Germany raised €6.94 billion ($10.41 billion), Greece raised €3.09 billion ($4.64 billion), and Portugal divested assets worth €2.22 billion ($3.44 billion) during 2008, but no other EU countries raised more than €2 billion.

Privatization Deals in the European Union, 1H2008

The first half of 2008 saw privatization proceeds for European Union fall to one of their lowest levels since privatization first spread to continental Europe from Great Britain in the late 1980s. Total proceeds from government divestments in the EU were only €19.67 billion ($30.68 billion), and the non-EU total was even lower, €11.28 billion ($17.59 billion). This yielded a global total of €30.95 billion ($48.27 billion), which was the lowest semester total since the Privatization Barometer began in 2004. Of course, this weakness reflected the extremely difficult conditions that prevailed in global financial markets during the first half of 2008—and no one at that time could have imagined that the second half of 2008 would be far worse. While the deterioration in macroeconomic performance of western economies was only modest during

Figure 2. Privatization in the Enlarged Europe: Total Revenues and Transactions 1977 - 2007



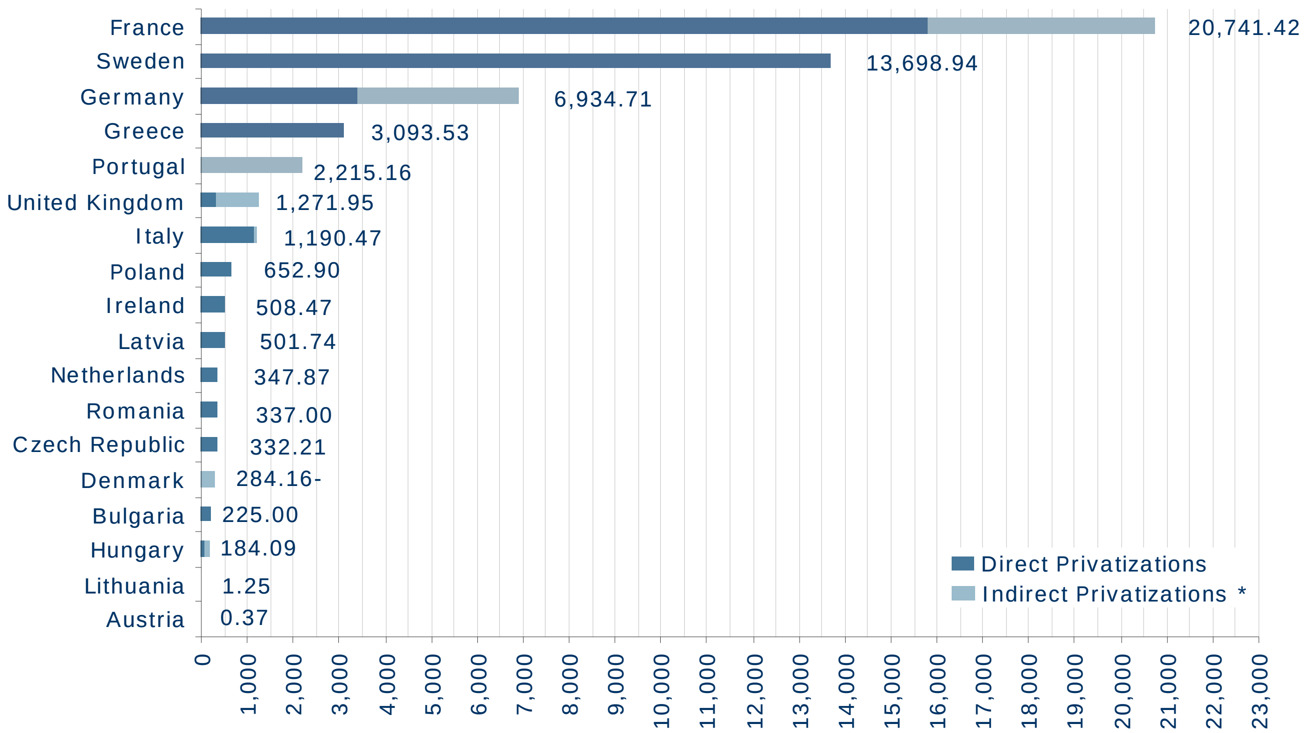
Source: *Privatization Barometer.*

1H2008, capital markets in Europe, North America, and Asia all were traumatized by the effects of America's sub-prime loan crisis, sharply declining stock price levels (see Figure 4), a sharp rise in global risk premiums, and a near collapse in new equity issues. The first quarter, in particular, saw initial public offerings shrink to levels not seen since 2001, and no fewer than 92 IPOs were canceled worldwide during 1Q2008 alone.

The privatization transactions in the European Union during 2008 are detailed in Table 1, with those deals from 1H2008 listed first. As can be seen, almost half (45%) of the EU total proceeds during the first half of the year were accounted for by the small country of Sweden. Though rarely cited as a major privatizer in previous years, the divestment program of the Centre-Right government of Prime Minister Fredrik Reinfeldt finally hit stride in 1H2008, with two successful sales totaling €8.74 billion ($13.63 billion). The first involved the February sale of Sweden's 6.7% stake in **OMX**, the region's pre-eminent stock exchange group, in a complex four-way deal that saw OMX being acquired by and merged with America's Nasdaq to form Nasdaq OMX. Sweden received a cash payment of €3.11 billion ($4.85 billion) and initially sold its stake to Börse Dubai, which then swapped these shares for a 19.9% stake in a new combined company and for Nasdaq's existing 22% stake in LSE, the London Stock Exchange. Shortly thereafter, the fourth player in the OMX takeover drama, Qatar Investment Authority (QIA), sold its entire 9.98% stake to Börse Dubai, bringing the latter's holdings above the 90% required to close the deal. These transactions made Börse Dubai the largest single shareholder in both Nasdaq and the LSE.

One month after its successful OMX divestiture, the Swedish government scored

Figure 3. Distribution of Privatization Revenues by Country, 2008



* Direct Privatizations refer to the sale of government's direct stakes. Indirect Privatizations include spin-offs and transfer of shares from government owned companies.

Source: *Privatization Barometer*

again by selling the beverage company **Vin & Spirit AB** in an auction that fetched a surprisingly high €5.64 billion ($8.80 billion) winning bid from France's Pernod. Most of the world's leading spirits groups participated in the auction, and to the very end the likely winner was thought to be Fortune Brands, the U.S. distributor of Vin & Spirit's flagship Absolut vodka brand. However, Pernod won the competition both on the basis of price offered and because it was the only major bidder willing to commit to preserving Vin & Spirits intact and as a Swedish company. Interestingly, Pernod's purchase of Vin & Spirits is prompting another auction of international distribution rights for a leading vodka brand—this time Russia's Stolichnaya, produced and sold in Russia by the SPI Group. Pernod has been the global distributor of Stolichnaya, and for antitrust reasons is being forced to sell these rights after buying Vin & Spirit.

Outside of Sweden, there were three truly large (€1 billion+) EU privatizations. The largest of these was the German local government's sale of its residential property company **Landesentwicklungs gesellschaft NRW** (LEG) to Whitehall funds. Whitehall funds acquired LEG in June this year from German state North Rhine-Westphalia in a deal that implied a company value of €3.4 billion ($4.9 billion). The other two large EU privatizations of 1H2008 occurred in Germany again (but the seller now is the central government) and Portugal, respectively, and both closed in the final month of the semester. The larger deal was the private sale of a 25.1% stake in the German chemicals, energy, and property group **Evonik Industries** by the state-owned foundation RAG-Stiftung to the private equity firm CVC Capital Partners. This sale netted RAG €2.4 billion ($3.7 billion), which the foundation is obliged to use to take over and service the massive liabilities of the German coalmining industry. The final large EU deal, and the only significant share issue privatization of 1H2008, was the €1.8 billion ($2.8 billion) IPO of a 25% stake in **EDP Renováveis**, the Portuguese renewable energy company and Energias de Portugal subsidiary. About two thirds of the shares were allocated in Spain and Portugal, and the retail tranche of this offer was 88 times subscribed, while the institutional tranche met with six times excess demand, though the stock declined in value by 4% on its first trading day—which turned out to be a down day for energy stocks everywhere.

Though not in the €1 billion+ category, two other EU deals of 1H2008 deserve explicit mention. The sixth largest EU divestment this period was an indirect privatization, involving the sale of Deutsche Telekom's **T-Systems Media & Broadcasting GmbH** unit to a German private equity fund. This disposal raised €850 million ($1.33 billion), and helped make Germany Europe's second largest private equity market (after Britain) for the first time. The final significant EU privatization of 2008's first semester was another complex telecom deal, this time involving the Latvian government's sale of its 51% stake in the mobile telephone operator **LMT** to TeliaSonera, which gave the Swedish-Finnish operator the 100% ownership it had always desired. In exchange, TeliaSonera transferred to the government its 49% stake in fixed-line operator Lattelecom, and also paid €187 million ($293 million) in cash. The total implied value of this deal to the Latvian government was approximately €500million ($782 billion).

Before turning to a discussion of privatizations outside of the EU, and of planned EU and non-EU sales for 2H2008, we should briefly mention two significant transactions that might or might not be considered "privatizations" using an inclusive definition of the term. First, the quasi-privatization deal of 1H2008 was the German state-owned development bank KfW's €3.0 billion ($4.7 billion) convertible bond issue in May, which was convertible into **Deutsche Telekom** shares that KfW owns. The real impact of this transaction on government ownership is, however, likely to be inconsequential, since this offering merely replaces a maturing bond issue with a conversion price of €17.50 per share - and DT stock is currently selling for around €11 per share. The long-running (27-month) planned merger of state-owned Gaz de France and the private utility Suez was the quasi-privatization deal of the 2h2008. It passed a critical milestone in May 2008, when GdF’s unions gave up their attempt to block this extremely controversial deal. The details have been disclosed in the next paragraph.

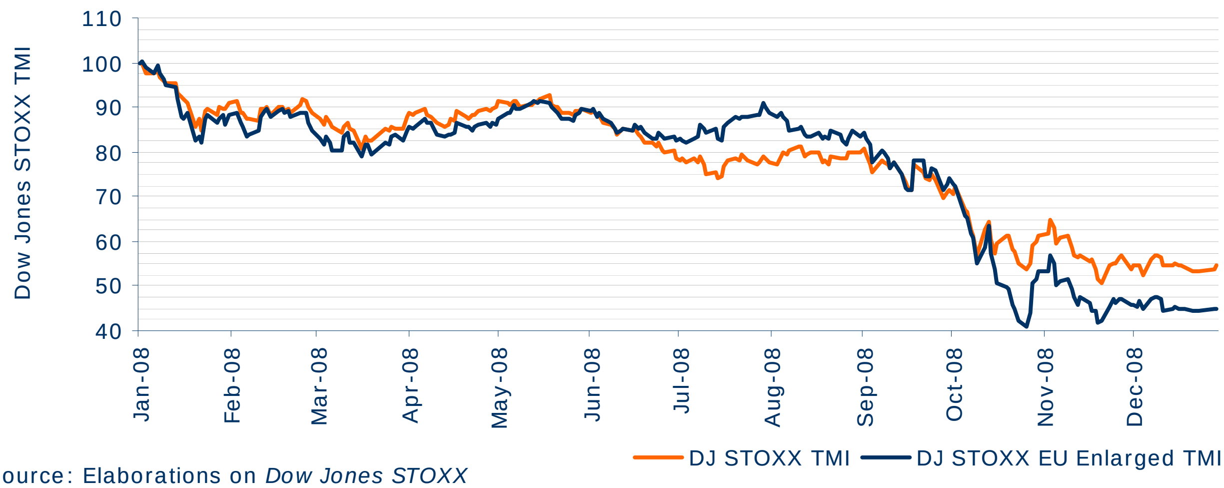
Privatization Deals in the European Union, 2H2008

There were eight privatizations in EU countries during 2H2008 worth at least €500 million each. The first and third largest of these took place in France and revolved around the merger of **Gaz de France** (GDF) and Suez. The merger itself was finally approved, overwhelmingly, after two years of political maneuverings and labor union opposition by the shareholders of both companies in July 2008. The majority state-owned GDF, with a market value of €15.30 billion ($22.03 billion), was combined with Suez - in which the state owned a 34.7% stake - to form the second largest utility group in Europe, with a market capitalization of €92 billion ($132.48 billion) and residual state ownership equal to 35.7% of the new GDF Suez. The merger terms also required that Suez must divest its environmental subsidiary, and so the IPO of a 60% stake in Suez Environmental launched immediately after the merger closed and raised €4.65 billion ($6.70 billion).

The second largest EU privatization of 2H2008 was the sale of the wholly state-owned property company **Vasakronan** by the Swedish government to AP Fastigheter in July, which yielded proceeds of €4.95 billion ($7.06 billion). Though not apparent at the time, this marked the last sale of Sweden’s two year old privatization program, almost exactly halfway through the planned six divestments, due to the global collapse in stock market values.

Only two other EU privatizations raised over €1 billion during 2H2008. The larger of these was the Greek government’s July award of a **35-year concession** to manage the **Port of Piraeus** (Athens) to the Chinese company Cosco in exchange for a payment of €3.09 billion ($4.36 billion). The final large deal of the second half of 2008 was the Italian government’s divestment - after years of largely fruitless efforts and multiple “one last time” capital infusions - of its residual 49.9% stake in **Alitalia** to a consortium of Italian industrialists for €1.05

Figure 4. Equity Markets in EU25, 2008



Source: Elaborations on *Dow Jones STOXX* billion ($1.56 billion).

The sixth largest divestment of 2H2008 was, in all too many ways, emblematic of the financial market turmoil that roiled global markets during this period. In September, the British government nationalized the failing bank **Bradford and Bingley**, and then almost immediately (after 12 hours) sold the bank's £21 billion savings deposits and branch network to Abbey National plc (owned by the Spanish bank Santander) for €795.60 million ($1.11 billion). The seventh largest EU divestment of 2H2008 was the only large deal from New Europe during the semester. This was the November purchase of a 23.5% stake in the IPO of Poland's electric utility **Grupa Energetyczna ENEA** SA by the Swedish energy group Vattenfall for €532 million ($737 million). The final large EU deal of 2H2008 was the July sale by Ireland's **Energy Supply Board** of four power plants to Spain's Endesa for €508 million ($706 billion).

Sales Outside of Europe during 1H2008

For once, China's privatization program did not rescue investment bankers' profits during the first six months of 2008. In fact, there were only four large Chinese IPOs during 1H2008, which collectively raised €7.74 billion ($12.07 billion), and no large seasoned equity offerings at all. This means that Sweden (population 9 million) raised more privatization revenues during this period than did China (population 1.33 billion). This is a far cry from 2007, when China sold more than $65 billion in stock, but the decline is understandable given that by June 2008 the Shanghai Composite Index's value had fallen by more than half from its October 2007 peak. Stock markets were down around the world during the first half of 2008, but few markets saw as precipitous a decline as did China.

As has become customary, most of the Chinese IPOs were exclusively A-share (Rmb–denominated) offerings on the Shanghai Stock Exchange. The year's first IPO was January's offering of **China Coal Energy**, the country's second largest coal producer, which raised €2.31 billion ($3.60 billion). The shares closed the first day's trading at a 31.9% premium to their Rmb24 offering price, which would have been impressive in most markets—but was considered disappointing to Chinese market watchers.

Shortly thereafter, the China Pacific Insurance company cancelled a long-planned IPO due to market turbulence and poor pricing. However, other companies decided to proceed, and the next up was **China Railway Construction Corporation**, the former railway-building unit of the People's Liberation Army. China Railway raised €3.65 billion ($5.70 billion) in an early March IPO executed on both the Hong Kong and Shanghai exchanges. Although the offering was at least 250 times subscribed, it opened with a disappointing (by Chinese standards) first day initial return of 28%.

The third and fourth Chinese IPOs of 1H2008 were both A-share offerings executed during the second half of April. **Jinduicheng Molybdenum** came first with an €814 million ($1.27 billion) offering that achieved the best first day return to date, 36.1%. This was eclipsed two weeks later, however, when the shares of **Zijin Mining** nearly doubled (95.2% premium by day's end) on their first day of trading. This offer by the largest gold producer in the world's biggest gold producing country raised about €1 billion ($1.5 billion) to support the company's business expansion plans.

Outside of China, non-EU privatizations during 1H2008 also produced historically meager totals. Several key players from previous periods, including

Russia and Korea, executed no sales whatsoever, while the only large Brazilian divestment planned for this period - the €2.43 billion ($3.8 billion) trade sale of the municipal utility **CESP -** had to be canceled due to a lack of serious bidders. This same problem forced the cancellation of Algeria's long-awaited sale of a 51% stake in **Crédit Populaire d'Algérie**, though in fairness it should be pointed out that a variety of firm-specific rather than macroeconomic or Algeria-specific factors forced out key bidders. Citigroup had just fired its CEO, Chuck Prince, and France's Société Genérale had just realized the full extent of the losses (over €7 billion) it would suffer from a rogue trader's actions.
Still, there were at least five significant and completed privatizations during 2008's first semester. Two of these were executed by the Turkish government. In February, the government conducted an auction for **Tekel Cigarette**, out of which British American Tobacco emerged the winner after submitting a €1.10 billion ($1.72 billion) bid. This amounted to a rich, though not excessive, valuation of Tekel at 11.4 times the company's 2007 EBITDA. Then in May came the long-delayed IPO of a 15% stake in **Turk Telecom**, which raised €1.22 billion ($1.90 billion), bringing the government's holdings to 30% (it sold a 55% stake to Oger Telcom of Dubai in 2005). Some 65% of the shares were allocated to foreigners, who now own about 70% of the stock listed on the Istanbul Stock Exchange. The Turkish government has an ambitious privatization program with plans to sell off some €9 billion ($14 billion) worth of infrastructure and other assets over the next few years. The most imminent sale will likely involve the divestiture of **Izgas**, the municipally-owned gas company located in the important industrial town of Izmit, which might raise €800 million ($1.3 billion).

1H2008 was not altogether dismal for privatization in Africa and South Asia, as both regions witnessed important, if unusual, state sales. In March, Kenya sold a 25% stake in the mobile telephone operator **Safaricom** in a wildly popular IPO that netted the government almost €500 million ($775 million). This reduced the Kenyan government's stake to 35%, with Vodafone holding an additional 35%. The shares, which were offered to citizens at Ksh5.00/share and to foreigners (who were allocated 35% of the offering) at KSh5.50/share, yielded a first day return of 50% to domestic purchasers when the shares began trading in June. After listing, Safaricom accounted for no less than one-quarter of the Nairobi Stock Exchange's total market capitalization, and a much higher fraction of daily trading volume. India's contribution to privatization history came in January, when the state-owned body governing cricket raised €464 million ($724 million) by selling eight new **Twenty20 team franchises**, principally to corporate buyers. This popular new cricket variant involves games lasting a few hours rather than several days, as is common in the traditional format.

The final privatization of 1H2008 was a completed sale, but hardly a success. This was Vietnam's January IPO of Saigon **Beer and Alcohol Beverage** (Sabeco), which the government was able to sell only 78.4 million shares rather than the 128.3 million (representing 25% of the company's shares) on offer—and thus raised €219 million ($341 million) rather than the hoped-for €358 million ($558 million). This offering crystallized two key problems that have bedeviled several recent Vietnamese privatizations. The first is the government's insistence on attaining the maximum possible offering price in all sales and, second, its related insistence on a trade-sale pricing methodology requiring potential buyers of strategic stakes to pay the average price generated in a Dutch auction. The first provision was a serious problem for the Sabeco sale, since the government set the minimum bid price at 70,000 dong—an astonishing 72 times projected 2007 earnings presented in the offering prospectus. The latter provision has proven to be particularly scary for prospective buyers of a series of financial companies—banks and insurers—that the Vietnamese government has offered for sale over the past year. All failed to attract major strategic partners, despite massive interest in the country, which is growing extremely rapidly (even by Southeast Asian standards) and is seriously “under-banked” by all normal measures. As one commentator, quoted in Financial Times (April 23, 2008), shrewdly put it: “They [the Vietnamese government] hope to get someone to commit to an unknown price… But no board in the world of a multinational company would go for that. It is like writing a blank cheque.”

Sales outside of Europe during 2H2008

There were four large privatizations executed by governments outside of Europe during the second half of 2008, including the largest share issue privatization ever by a Latin American company. This was the August seasoned equity offering of common and preferred shares of **Companhia Vale do Rio Doce** that raised a net (after underwriting discounts and commissions) €8.68 billion ($12.06 billion) in new capital for the firm. Although Vale had originally hoped to raise one-third more, and had to scale the offer back due to adverse market conditions, the primary offer was well received and underwriters exercised their full over-allotment option to meet excess demand for Vale shares.

Two other non-EU privatizations raised very similar amounts, around €2 billion, during 2H2008, even though the governments involved could hardly be more different from each other. In September, the U.S. government finally completed its first large-scale sale of a major airport, **Chicago’s Midway**, to a consortium that included Vancouver Airport and that netted €1.84 billion ($2.50 billion). Before completing this sale, the government had to secure approvals from airlines controlling at least 65% of traffic in and out of Midway, which it successfully did. Three months later, the **Singaporean** government conducted an auction of the country’s **largest power station**, which was won by a consortium led by Japan’s Marubeni and France’s GDF Suez that agreed to pay €3.50 billion ($2.57 billion) in cash and assume €440 million in debt ($323 million).

The final large non-EU privatizations of 2H2008 had a very familiar feel, since it was the only Chinese A-Share IPO of the semester. Whereas Chinese companies raised over $43 billion in no fewer that twelve IPOs during 2H2007, the August 2008 IPO of **China South Locomotive & Rolling Stock** raised only €1.08 billion ($1.50 billion). Nonetheless, the offering was over 300 times subscribed and the shares closed 58% above the offering price on the first day’s trading.

Failed and Canceled Privatizations during 2008

One very natural, if unfortunate, by-product of the market turmoil that gripped global capital markets during the second half of 2008 was that a large number of planned privatizations were either canceled or failed outright. World stock markets declined almost monotonically over the course of this very bad year, with the greatest falls occurring after August. As could be expected, most cancellations of individual sales and national programs occurred during the last four months of the year. Sweden, Turkey, and South Korea all effectively suspended ambitious divestment programs during the fourth quarter of 2008, although the biggest single cancellation occurred in July when France Telecom withdrew its €26.2 billion ($41.3 billion) offer for the Swedish-Finnish telecom company TeliaSonera. FT had broached the idea of a merger—it was not really an acquisition offer at first—in early June, with an indicated offer price of Skr55.22/share (€5.87, $9.16), for a total value of €26.2 billion ($41.3 billion).

The Swedish Establishment, in general, and TeliaSonera's board in particular, immediately rejected the bid as inadequate, and began the search for a competing bidder. This search failed at the same time that FT's market valuation was falling sharply, so the French Telecom called it quits in July—to the intense joy of its own shareholders and the chagrin of Sweden's government and TeliaSonera's shareholders.

The second largest failure of a major privatization deal occurred in October, when the consortium that had bid €9.22 billion ($12.8 billion) for the 30-years right to operate the Pennsylvania Turnpike—the first modern toll road in the United States, built during the 1930s. In this particular case, the *casus belli* was political discord rather than market turmoil, specifically the failure of the Pennsylvania legislature to pass enabling legislation after the winning bid was accepted. Immediately after this deal collapsed, Pennsylvania Governor Ed Rendell vowed to resurrect the Turnpike sale during 2009, but to obtain legislative approval for the sale before rather than after accepting bids.

The third, and in many ways the signature cancelled privatization occurred in November, when the German government cancelled the IPO of a 25% stake in the state railway company Deutsche Bahn. This sale had been mooted for many years, and was headed towards a sale that would have raised over €6 billion ($8.3 billion) in badly needed new capital for the company, but falling stock values scuttled the plan. While the government vowed to re-launch the D-Bahn IPO once markets recover, national elections during 2009 seemed certain to complicate the sale even if markets ultimately bounce back. Politics trumps economics. As was the case with the Pennsylvania Turnpike, it was the failure of the legislature of the Australian state of New South Wales to approve the proposed A$10 billion sales of state-owned power plants that doomed this sale rather than the depressed market valuations, per se, though this also contributed to the divestment's failure. Finally, 2008 offered two examples of re-nationalization, one of which amounted to outright expropriation. This occurred in December, when the lower house of Argentina's parliament approved a bill to re-nationalize Aerolineas Argentinas without compensation to the Spanish travel company that had owned the airline. The other case was less dramatic, though no less final. This was the German government's re-nationalization of the printing company that produced currency banknotes. This firm had been sold to Apax Partners, a private equity company, in 2000, but the company had been unable to support the heavy debt taken on by Apax to pay for the acquisition (and to finance payment of a large post-purchase cash dividend), and was re-acquired by the government for a nominal sum two years later. After Germany tried and failed to auction this company again, the government simply brought it back into the state-owned enterprise fold.

Planned Sales in 2009

The 2009 starts with a huge transaction: the French nuclear power company Électricité de France (EDF) has formally purchased **British Energy** for €13.5 billion ($18 billion). After more than a year of speculation about bids and then negotiations, EDF has formally taken over British Energy, the largest electricity generator and nuclear operator in Britain. Included in the sale was the 36-percent stake that previously was held by the UK government's Nuclear Liabilities Fund which brought in about €4.8 billion ($6.4 billion).

Hope springs eternal, and several governments were nurturing plans for large privatization programs and/or individual company sales as the year 2009 began. Five European countries were hoping to sell three national airlines to other operators, and this was rendered a potentially possible task following the dramatic decline in oil prices during the second half of 2008. The three national governments that collectively own 50% of **Scandinavian Airline Service** (SAS) - Norway, Sweden and Denmark - entered negotiations with Lufthansa (and with SAS's own labor unions) with an eye towards divesting the loss-making airline to the German company. Ironically, Lufthansa emerged as the only serious bidder for the much more troubled **Austrian Airlines**, and at year-end 2008 it appeared that Lufthansa would be able to acquire this airline for a trivial sum, end even then after the Austrian government agreed to assume much of the company's large debt. The third planned airline divestment has, like Italy's Alitalia, been a tortured work-in-progress for many years. In November 2008, the Greek government announced that it had received 13 expression of interest in acquiring **Olympic Airlines** flight operations, and 25 for the airline's ground operations, far more the Greek government expected. Regarding the air transportation industry, also the Spain's airports **AENA** will be allowed to partially privatize under a new plan unveiled by the government's Ministry of Public Works. Cabinet Minister Magdalena Alvarez cited several reasons for the new privatization effort: guarantee the security and the quality of the airport services to take care of increasing demand and guarantee the financial autonomy of the airport system. She put an economic value of EUR30 billion ($46.7 billion) on AENA's airports.

Once more in Spain, another important announcement of privatization has been done about the utility **Canal Isabel II**. The regional government of Madrid plans to sell off 49% of its water utility on the stock exchange. The utility provides drinking water for almost 6 million people. The other major planned EU privatization was first mooted in July 2008 by a newly energized and confident Sarkozy government in France. This was the possibility of allowing private capital to invest in **La Poste**, the massive 100% state-owned postal service and savings bank. The French bank hired to advise the government on La Poste's partial privatization, Rothschild, predicted that a successful floatation could value the company as high as €10 billion ($15.7 billion). While such a sale would require a change in legislation, this may well occur during 2009 or 2010.

Outside of Europe, the most important active privatization program is that announced by **Egypt** in November 2008 and planned for execution during the first half of 2009. This is a mass privatization program involving the free distribution of shares in **85 state-owned companies** to all Egyptian citizens. Government policy-makers stress that they understand the problems that resulted from the Central and Eastern European voucher privatization programs of the 1990s and vow that the Egyptian program will involve a distribution of real shares, rather than exchangeable vouchers, and that the state would continue operating most of the companies (those with a residual government ownership of at least 30%) until real private owners emerged. This program will be a key test of privatization in emerging markets, generally, and in Islamic countries in particular. In August 2008, the Indian government announced plans to privatize the telecom operator **Bharat Sanchar Nigram Ltd** (BSNL) through the country's largest ever IPO. This announcement was rich in irony, because the sale only became politically feasible due to the recent withdrawal of the Communist Party - which had blocked all privatization efforts - from the governing coalition, yet the contemplated sale was announced as global stock markets were crashing. This forced the planned sale of a 5-10% stake in BSNL, which the hopes might raise up to €7.75 billion ($10 billion), to be delayed until 2009 at the earliest. Finally, at least one other non-EU government hopes to execute a telecom privatization this year. The Omani government announced in July 2008, just before global stock markets collapsed, that it hoped to auction off a 25% stake in **Oman Telecommunications** and raise up to €850 million ($1.1 billion). This proved impossible last summer, but may well occur during 2009.

Table 1. Deals, 2008

Date	Company Name	Nation	Sector	% for Sale	Value (€ mil)	Direct / Indirect Sale*	Method of Sale
07/17/08	Gaz de France	France	Utilities	44,10	15.302,70	Direct	PO
03/31/08	Vin & Sprit AB	Sweden	Manufacturing	100,00	5.637,66	Direct	PS
07/07/08	Vasakronan	Sweden	Finance	100,00	4.949,64	Direct	PS
07/22/08	Suez Environment	France	Utilities	52,84	4.649,92	Indirect	IPO
06/14/08	LEG Landesentwicklungs gesellschaft NRW GmbH	Germany	Finance	100,00	3.400,00	Direct	PS
02/15/08	OMX	Sweden	Finance	6,70	3.108,06	Direct	PS
07/16/08	Port Of Piraeus (35-year concession)	Greece	Transports	100,00	3.093,53	Direct	PS
06/20/08	Evonik Industries (RAG Foundation)	Germany	Manufacturing	25,00	2.400,00	Indirect	PS
06/04/08	EDP Renovaveis (EDP)	Portugal	Utilities	25,00	1.800,00	Indirect	IPO
11/19/08	Alitalia	Italy	Transports	49,90	1.052,00	Direct	PS
01/15/08	T-Systems Media&Broadcast GmbH (Deutsche Telekon	Germany	Tlc	100,00	850,00	Indirect	PS
09/29/08	Bradford & Bingley PLC-Retail Deposit Business	United Kingdom	Finance	100,00	795,60	Indirect	PS
11/12/08	Grupa Energetyczna ENEA SA	Poland	Utilities	23,50	531,87	Direct	IPO
07/31/08	Electricity Supply Board (ESB)	Ireland	Utilities	20,00	508,47	Direct	PS
04/15/08	LMT	Latvia	Tlc	51,00	501,74	Direct	PS
12/08/08	Aeroports de Paris	France	Transports	8,00	498,70	Direct	PS
03/30/08	Compal	Portugal	Manufacturing	80,00	415,16	Indirect	PS
12/11/08	Luchthaven Schiphol NV {Schiphol Group}	Netherlands	Transports	8,00	347,87	Direct	PS
07/10/08	ArcelorMittal's Czech unit	Czech Republic	Manufacturing	11,00	327,40	Direct	PS
09/09/08	Qinetiq Ltd	United Kingdom	Services Industry	18,90	325,76	Direct	AT
04/17/08	Muntenia Sud	Romania	Utilities	67,50	280,00	Direct	PS
04/25/08	SAS Facility Management (SAS)	Denmark	Services Industry	100,00	233,31	Indirect	PS
05/15/08	Bulgarian Marine Operator	Bulgaria	Transports	70,00	225,00	Direct	PS
10/24/08	Edison SpA- Hydroelectric	France	Utilities	100,00	203,48	Indirect	PS
12/23/08	WSW Energie & Wasser AG	Germany	Utilities	33,10	152,82	Indirect	PS
01/14/08	Alfold Koncesszios Autopalya	Hungary	Construction	39,48	113,65	Indirect	PS
04/30/08	Milan Undisclosed Building Portfolio	Italy	Finance	100,00	102,00	Direct	PS
04/01/08	ICTS Europe Holding BV (Fraport AG)	Germany	Services Industry	100,00	100,00	Indirect	PS
01/18/08	Project Services Ltd (BNFL)	United Kingdom	Services Industry	100,00	93,31	Indirect	PS
06/30/08	Zaklady Azotowe Tarnow	Poland	Manufacturing	40,00	87,00	Direct	IPO
01/11/08	Elmu Rt	Hungary	Utilities	10,50	70,44	Direct	PS
03/20/08	Automobile Craiova	Romania	Manufacturing	72,40	57,00	Direct	PS
05/30/08	COFATHEC Coriance (COFATHEC)	France	Services Industry	100,00	44,60	Indirect	PS
04/01/08	BBC Resources (Outside Broadcasts)	United Kingdom	Tlc	100,00	34,71	Indirect	PS
07/14/08	Hejre Licence	Denmark	Petroleum Industry	10,00	34,53	Indirect	PS
07/17/08	Polfa Grodzisk	Poland	Manufacturing	29,60	31,05	Direct	PS
05/14/08	Luebecker Hafen Gesellschaft mbH	Germany	Transports	25,10	31,79	Direct	PS
08/06/08	Societa Cartolarizzazione Immobili Pubblici Srl	Italy	Finance	100,00	27,50	Direct	PS
01/31/08	Dagris	France	Manufacturing	51,00	25,00	Direct	PS
03/01/08	Defence Aviation Repair Agency {DARA}-Rotary Wing	United Kingdom	Transports	100,00	22,57	Direct	PS
06/26/08	EnergiGruppen Jylland A/S- Water & District Heating A	Denmark	Utilities	100,00	16,32	Indirect	PS
03/03/08	Seeboard Trading Ltd	France	Construction	100,00	10,19	Indirect	PS
09/26/08	Termica Boffalora Srl	France	Utilities	12,86	6,84	Indirect	PS
10/17/08	Acea Luce SpA	Italy	Utilities	100,00	5,81	Indirect	PS
02/25/08	Skodaexport Co Ltd	Czech Republic	Services Industry	100,00	4,81	Direct	PS
09/21/08	NordCargo Srl	Italy	Transports	49,00	3,16	Indirect	PS
11/21/08	Astrid Lindgrens Varld AB	Sweden	Services Industry	90,00	2,46	Direct	PS
09/10/08	Przedsiebiorstwo Produkcji Kruszyw w Dzialdowie	Poland	Manufacturing	42,41	1,28	Direct	PS
04/08/08	Vilniaus Sigma AB	Lithuania	Manufacturing	15,21	1,25	Direct	PO
04/02/08	Parkab Overvakning AB (Stockholm Parkering)	Sweden	Services Industry	100,00	1,13	Indirect	PS
05/19/08	ZEC ENERGOSERVICE Sp zoo	Poland	Utilities	42,06	0,76	Direct	PS
12/05/08	Austrian Airlines AG	Austria	Transports	41,56	0,37	Indirect	PS
12/05/08	Powiatowe Centrum Zdrowia Sp zoo	Poland	Services Industry	90,00	0,36	Indirect	PS
12/01/08	Glimar SA	Poland	Petroleum Industry	91,54	0,24	Indirect	PS
07/16/08	Koninskie Przedsiebiorstwo Budowlane SA	Poland	Construction	25,43	0,17	Direct	PS
05/28/08	Irpack Zaklad Projektowania i Produkcji Opakowan sp	Poland	Manufacturing	57,07	0,16	Indirect	PS
07/01/08	AirIT International GmbH	Germany	Services Industry	50,00	0,09	Indirect	PS
Total 1H2008		**30 Transactions**			**19.667,62**		
Total 2H2008		**27 Transactions**			**32.853,60**		
Total 2008		**57 Transactions**			**52.521,22**		

* Direct Privatizations refer to the sale of government's direct stakes. Indirect Privatizations include spin-offs and transfer of shares from government owned companies. Parenteses report the Parent/Seller Company name.
Method of Sale: AT (Accelerated Transaction); IPO (Initial Public Offerings); PO (Public Offering); PS (Private Sale).
Source: Privatization Barometer.

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GCC Countries: Liquidity Crunch, Reforms and Sovereign Wealth Funds

The Gulf Cooperation Council (GCC) countries occupy an important economic and strategic position on the world stage due to their oil wealth: no other region in the world has such a small population in possession of such large hydrocarbon reserves (Economic Research Bulletin, GRC, 2008). According to the 2008 World Economic Forum's Competitiveness Report, GCC nations are the most competitive in the Middle East, making them attractive Foreign Direct Investment (FDI) destinations. The region, including GCC, has been one of the fastest growing regions in the world (GDP growth of 7%) over the last three years, after China and India.

The extraordinary increase in the price of crude over the past decade has endowed the Gulf economies with sizable amounts of cash. In varying degrees, all GCC nations are now seeking to reduce their economic dependence on oil and gas. To this end, much of the money that comes from oil and gas is invested abroad, often through sovereign wealth funds (SWFs), which have become, lately, important financial actors on international markets.

Despite their positive outlook and prospects, the six GCC countries could not avoid the storm, and the credit crunch hit home, with potential consequences on their diversification efforts and their growth models, largely based on the real estate sector. We provide in what follows a global assessment of the GCC state of the economy and of the exposure of the region to the crisis, and describe how this latter affected GCC markets, and their banking and finance sectors. We put a particular emphasis on the governments' response and bailout programs aimed to tackle the crisis, and on the role played by SWFs in the process. We conclude with an overview of the principal future challenges facing this important region of the world.

Overview

The GCC, or Gulf Cooperation Council, was created in 1981, and covers an area of 2673 000 km^2, with a population of 36.2 million. The member states of GCC are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates

Table 1. Key Details about GCC Countries

Name	Capital	Population	Area (km²)	GDP (mil. US$)	Per capita (US$)
Bahrain	Manama	1.046.814	716	15,354	23,604
Kuwait	Kuwait City	2.460.000	17,818	95,924	39,3
Oman	Muscat	2.534.000	309,5	35,99	19,879
Qatar	Doha	1.307.229	11,437	52,722	80,87
Saudi Arabia	Riyadh	26.417.599	2.240.000	572,2	21,2
United Arab Emirates	Abu Dhabi	4.588.697	83,6	163,296	55,2

Source: GCC website (*www.gcc.sg.org*)

(UAE). The basic objectives of the GCC are to strengthen relations and cooperation, and to formulate similar regulation in various fields including the following: economic and financial affairs, commerce, customs, communications, education and culture; to stimulate scientific and technological progress in the fields of industry, mining, agriculture, water and animal resources; to establish scientific research; to establish joint ventures and encourage cooperation by the private sector between the member states.

These countries have a collective GDP of about $1,022.62 billion (IMF statistics, 2008) which makes them the 16th largest economy in the world. These oil-exporting countries use their oil and gas revenues to finance their economic growth and development. They do not depend on taxation to pay for their expenditures (they are, therefore, rentier states). The GCC has some of the highest negative real interest rates in the world. The 15 to 20 percent inflation encourages borrowing, thus higher corporate debt levels and the formation of asset bubbles (www.moneyworks.ae).

The GCC market capitalization of the more than 650 listed companies (2008) is about $1.3 trillion, greater than that of Russia. These markets are the least correlated emerging markets with the S&P500 and Dow Jones indices.

The 10 largest listed companies in the GCC are all state-owned (including SABIC, Emirates Bank, Qatar Telecom). Most are banks, telecoms, or materials (e.g. SABIC). The private sector is dominated by family business firms, mostly organized as big conglomerates, that remain unlisted, and where family members hold key executive positions. Private firms are concentrated in services, trade and construction, while energy, banks and utilities remain state-owned. The financing pattern of GCC firms is mostly through retained earnings (75% on average), and to a lesser extent banks (Sager, 2007).

Privatization

Apart from a few exceptions, such as Saudi Telecom, privatization in the region has been very slow, unlike other countries in the Middle East and North Africa (MENA) such as Egypt, Morocco, and Jordan. Instead, Public Private Partnerships (PPP) have emerged as an important alternative for outright divestiture. PPP are programs of cooperation between the public and private sector for the provision of public services by private enterprises. They thus constitute a compromise between government monopoly and outright privatization. One such example is Saudi Ports Authority, which is owned by the state, but has been operated by private service providers since the privatization of its operations in 1997.

In 2004, the Dubai Government privatized its building development program with the Emaar Properties IPO. Future privatizations have been announced by GCC countries, particularly in the telecoms industry.

The Exposure to the Crisis

The subprime exposure of GCC banks was first considered as minimal. GCC countries have an estimated $1.8-2 trillion in foreign assets (end of 2008), about 60 percent of which are held in US dollars, thus exposing them to asset depreciation.

In the wake of the crisis, however, the real estate bubble in GCC countries burst, and real estate companies and mortgage companies were hit hard. The crisis then spread to become a general liquidity crunch as substantial foreign funds left the region, leading to increased costs of funding and bond spreads, and exposing both banks and sovereign wealth funds to asset write-downs. The liquidity

crunch was further exacerbated by the depressed demand for GCC oil, petrochemicals and aluminum.
The exposure of GCC banks to Lehman's bankruptcy in the form of derivative trades (e.g. credit default swaps) or structured investment products was mitigated according to the UAE's Central Bank and the Saudi Arabian Monetary Authority (SAMA), while the Central Bank of Bahrain conceded that Bahraini banks could be carrying some exposure to Lehman Brothers. As of February 2008, the following sub-prime related losses have been announced: Bahrain's Gulf International Bank (about $1 billion); Kuwait's Gulf Investment Corporation ($246 million); the Arab Banking Corporation of Bahrain ($1.2 billion). In addition, the significant loss in the market capitalization of GCC insurance companies may be indication of their exposure to dealings with AIG, the US insurance giant. Overall, the subprime exposure of GCC banks is estimated at about $2.7 billion.

The indirect exposure to the subprime crisis later materialized in increased borrowing costs, leading to a liquidity crunch and credit exposure for local investors, and especially for project and real estate financing. To make things worse, significant foreign funds that entered GCC betting on the currency revaluations across the Gulf Region (whose currencies are pegged to the dollar), were withdrawn starting in June 2008. The reversal of these speculative foreign exchange positions, worth about $30 billion in the UAE alone, according to the Middle East and Central Asia department at the IMF, contributed to the stock market fall out.
The UAE was the first GCC country whose government announced guarantees for bank deposits thus echoing similar measures in the US and Europe. Subsequently, the UAE central bank has tried to alleviate liquidity bottlenecks by providing an additional Dh50 billion short-term facility to banks.

The Impact of the Crisis on GCC Islamic Banking and Finance

The global Islamic banking industry is worth as much as $1 trillion, according to estimates by the Asian Development Bank. In 2005, GCC countries accounted for 20 percent of the paid up capital, 35 percent of the assets, 45 percent of the deposits and 39 percent of the net profit of the Islamic banks world-wide.
Several reports claim that GCC Islamic banking has largely escaped the negative impact of the crisis, mainly thanks to the rules that are applied in these banks. According to the rules of Islamic banking and finance, for instance, the payment and collection of interest is prohibited. Also, complex instruments such as derivatives and other creative accounting practices, including short selling, are banned. Additionally, transactions must be backed by real assets and there is an incentive for these institutions to ensure that the deal is sound, since the transactions require that the risk be shared between the bank and the depositor. Nevertheless, several experts argue that, because of its heavy reliance on property investments and private equity, Islamic banks are not immune to market turbulence.
Several projects financed by Islamic banks have been postponed or delayed due

Table 2. Announced Asset Write-downs Related to the Subprime Crisis

Bank	Write-downs in US$ million
Abu Dhabi Commercial Bank (UAE)	272
Gulf Investment Corp (Kuwait)	246 (another 200 expected)
Gulf International Bank (Bahrain)	966
Arab Banking Corporation (Bahrain)	1200

Source: E. Wortz. GRC, October 2008

to the liquidity crunch. Some companies, including Kuwait's Abyaar Real Estate Development Co and Malaysia's Perisai Petroleum have either put on hold or scrapped plans to sell Islamic bonds, citing tougher market conditions. The collapse of the real estate sector has thus affected the booming GCC Islamic banking industry.

The Down-Turn In GCC Markets.

The crisis directly impacted the stock markets in the Gulf region: in both Saudi Arabia and the UAE (Dubai), indices have lost more than 40 percent since the beginning of 2008. The same happened in the Kuwaiti Stock Exchange (KSE), the first bourse in the GCC, which is now down 45% since January 2008. Trading in the market was halted for three days in November 2008 by an administrative court, and was reopened only after a successful appeal by the Kuwait Stock Exchange. The Fitch credit rating agency lowered the ratings (on December 28, 2008) of 15 banks in the GCC area, (including seven banks in Saudi Arabia, and four in UAE) due to the impact of the growing global crisis on the region. Fitch Ratings also downgraded the credit rating of Kuwait's Global Investment House (GIH), an investment bank, cutting its long-term Issuer Default Rating to 'C' from 'BBB', because GIH had failed to meet a debt obligation on December 15 due to cash flow problems (Kuwait Times, December 2008; GCC equities.com).

Fitch Ratings also downgraded in November 2008 the ratings of Dubai Holding Commercial Operations Group LLC’s (DHCOG) and Dubai Electricity and Water Authority (DEWA) from AA minus to A plus due to a difficult macro-economic environment. But the ratings continue to benefit from potential support from the government and Dubai’s strong position and role within the UAE federation. Similarly, Standard & Poor’s Ratings Services revised their outlook on the ratings of six Dubai-based Government-Related Entities (GREs) to negative from stable, reflecting the worsened economic outlook (Gulf Times, december 2008).

Government Bailouts of the Banking System

According to a report by Moody’s Economy, Gulf states are increasingly turning to government rescue programmes similar to the U.S. Treasury’s bail-out programme, especially as oil prices have been falling, further undermining investors’ confidence. The UAE, Kuwait, Saudi and Qatar have all moved to support their national banking systems. Saudi Arabia and the UAE have already poured up to $10 billion into their banks to ease tight liquidity conditions. In September 2008, the United Arab Emirates central bank launched a $13.62 billion emergency facility to ease liquidity constraints in the interbank market. Dubai’s largest mortgage lenders, Amlak Finance and Tamweel, have been nationalized. Kuwait is the only GCC country to have been forced publicly to bail out a bank (the Gulf Bank which is the second largest in the emirate) after it

Table 3. Number of Listed Companies on GCC Stock Markets 2001-2006

Country	2001	2002	2003	2004	2005	2006
Bahrain	37	76	97	101	115	130
Kuwait	23	38	46	46	47	49
Oman	43	88	73	73	77	86
Qatar	24	75	128	127	132	127
Saudi Arabia	10	29	28	30	32	36
United Arab Emirates	33	41	108	120	158	180
Total	170	347	480	497	561	608

Source: GCC website (*www.gcc.sg.org*)

announced subprime related losses of $1.4 billion in derivatives trading.

Sovereign Wealth Funds as White Knights

The Kuwaiti sovereign wealth fund (KIA) is the second largest SWF in the GCC region, next to that of Abu Dhabi emirate's Abu Dhabi Investment Authority (ADIA) whose assets are worth around $900 billion KIA has more than $300 billion in reserves, and announced in September 2008 that it intended to invest as much as $15 billion in local capital markets. The Qatar Investment Authority (QIA) has also set aside a fund of $5.3 billion in October 2008 with the stated objective of buying up to 20 percent stakes in local Qatari banks.

Although this is not a traditional practice for Sovereign Wealth Funds, which usually try to diversify the economic capacity by investing in foreign non-oil assets, they have been called upon to rescue their respective local economies by investing in domestic stock markets that lost about $500 billion in value this year, mainly through large buy-back programs, lending and capital injections in troubled banks.

GCC Sovereign Wealth Funds Losses

However, these "white knights" have also been exposed to crisis. Several analysts claim that their exposure to the current market turmoil has been considerable. No public data about the size and composition of their assets is available, but several publicized high profile overseas' investments, as well as the falling price of oil and the shrinking foreign exchange reserves lead analysts to estimate the reduction of the total assets under management from $3,000 billion to as low as $2,300 billion (Morgan Stanley estimates). Capital injection into Merrill Lynch by the Kuwait Investment Authority (KIA)--along with other SWFs such as the Korean Investment Corporation, Mizuho Financial Group of Japan, and Singapore's Temasek--did not save Merrill Lynch, which was subsequently acquired by Bank of America for $50 billion in stock. Similarly, the Abu Dhabi Investment Authority (ADIA) purchased a 4.9 percent stake in Citigroup, whose loss in value may have cost ADIA about $3.4 billion (Woertz, 2008). Dubai International Capital, Istithmar [investment holding company] and DIFC Investments have taken stakes in HSBC, UBS, Standard Chartered Bank, Blackstone [private equity fund] and Deutsche Bank, all of which have been equally hit by the crisis. The Qatar Investment Authority also injected capital into Credit Suisse. Overall, the Gulf countries are said to have invested $140 billion in overseas investments in the last three years alone.

In January 2009, ADIA, the world's largest sovereign wealth fund, announced it did not directly invest in Investment Securities LLC whose owner Madoff had

Table 4. Sovereign Wealth Funds in the GCC

Country	Fund	Assets (US$ bn)	Inception	Rank
United Arab Emirates (UAE)	Abu Dhabi Investment Authority	875,00	1976	1
Saudi Arabia	SAMA foreign holdings	365,20	1990	3
Kuwait	Kuwait Investment Authority	264,40	1953	6
Qatar	Qatar Investment Authority	60,00	2003	12
UAE Abu Dhabi	MubadalaDevelopmentCompany	10,00	2002	29
Bahrain	Mumtalakat Holding company	10,00	2006	30
Saudi Arabia	Public Investment Fund	5,30	2008	32
Oman	State General Reserve Fund	2,00	1980	39
UAE-Ras el Khaimah	RAK Investment Authority	1,20	2005	40
GCC SWF assets		1.593,10		
% of total global SWF assets		41,60%		

Source: Sovereign Wealth Fund Institute, August 2008 been placed under house arrest. According to the New York Times, ADIA has entrusted Madoff with $400 million, but ADIA announced it only invested $132 million three years ago in the Fairfield Sentry Fund which could have suffered losses after its partial investment in Madoff Investment Securities. These numbers remain unverifiable and the extent of the impact of the crisis on GCC sovereign funds can thus only be subject to conjecture.

Six months ago, a ferocious debate raged in Washington and European capitals over whether sovereign wealth funds from the GCC and other emerging markets should be allowed to buy up stakes in financial and industrial companies in the West, on the grounds that this would jeopardize national security. In 2006, for instance, the U.S. House of Representatives passed legislation forbidding Dubai Ports World from operating ports in major American cities. New rules for more transparency and disclosure, as well as greater governance compliance, were adopted by these SWF during 2008.

Experts and analysts claim that sovereign wealth funds will continue to grow in the short and medium-term despite the crisis, and their long-term prospects remain positive. Several recent announcements have been made about on-going negotiations to acquire assets in depressed real estate sectors in both Europe and the United States.

Conclusion and Future Challenges

The extraordinary increase in the price of crude over the past decade has left GCC economies with considerable liquidity, which they have been investing around the world through their sovereign wealth funds to diversify their economies away from oil and gas. The global crisis showed that, contrary to the expectations, and despite their increased investment power and their liquidity endowments, GCC countries were not insulated from the global downturn. In this context, the necessity to make a transition from oil-based wealth and resource dependence towards a more diversified industry structure has become a question of primary importance.

In addition to the drying liquidity that resulted from the sharp decline in oil prices, and the urgency of restarting up the domestic credit cycle, several other important challenges to GCC states were brought forwards by the crisis, including rising inflation, relatively slow economic reforms, and domestic skill shortage. The currency peg to the dollar of GCC countries (except Kuwait) and the devaluation of the US dollar against major currencies over the last year, has resulted in an artificial imported inflation, leading GCC governments to speed plans for the creation of a common currency in 2010.

Several analysts are also calling for more extensive reforms, particularly towards more intensive privatization plans. Since attracting foreign institutional investment to the gulf region is often considered as a major requirement for future economic development, institutional reforms, to which privatization can contribute, are called for today, including creating strong governance systems, transparent practices and internationally accepted accounting regimes.

Outward foreign investment through SWFs is a backbone of the transition strategy of GCC countries away from oil-based wealth, and they will thus remain important players on the international financial scene.

Finally, GCC countries face a major problem related to the shortage of domestic skills, which creates a dependency upon foreign workers and technologies (as an example, 90% of the workforce in Dubai is foreign). The heavy reliance on non-national labour is a challenge that the GCC countries need to address.

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Bank Nationalizations: A History of the Credit Crisis of 2007- 2009[¥]

What started out as "pursuing the American dream" of increasing home ownership is now leading to bank semi-nationalizations across all developed countries. How did this happen? There are a number of factors, which are described below, that led to this historical slide of financial systems around the globe. Most of the problems originated in the United States but since so many other countries are heavily invested in America as well, the crisis took on global proportions. Stock markets almost everywhere experienced one of the worst years ever during 2008. In response to the fear of deep recessions and failing economies governments proposed significant bailout packages. Through these plans they offered liquidity-starved banks capital injections and insurance for some of their riskiest assets, in exchange for partial ownership. This article will describe the development of the 2008 credit crisis in the United States and its worldwide interconnections, and will detail the major actions taken by governments in their efforts to bring economies out of recession.

World stock markets showed the first signs of trouble in August 2007, though at that time no one knew or could forecast the magnitude of the problems to come. In early August 2007, some investors in the US became concerned with an emerging "credit crunch", or problems with borrowing, and a "subprime crisis," which refers to increasing default rates on certain mortgages. However, Ben Bernanke, the Chairman of the U.S .Federal Reserve Board (Fed) kept the target Federal Funds rate unchanged at 5.25%, citing a fear of inflation. The European Central Bank (ECB) had just increased its target rate to 4% a month before. On August 8, 2007, the European overnight rate spiked to 4.7% and the ECB pumped $129 billion into the system to increase liquidity. This was an emergency response from the ECB, which typically only adds liquidity in special auctions, unlike the Fed which intervenes in the overnight market almost daily. LIBOR (London Interbank Offer Rate), the rate that banks charge each other for funds, started to rise as investors demanded a large risk premium not previously witnessed. Behind these unusual events was a revelation by several European banks of their heavy exposure to U.S. subprime mortgages.

IKB, a German bank whose major shareholder is KfW (the state-owned development bank) announced that it had taken large bets on U.S. mortgages through its off-balance sheet entity, Rhineland. Rhineland became increasingly strapped for funds as it became difficult and expensive to borrow in the overnight commercial paper market. IKB was unable to bail out Rhineland, as it did not have the necessary funds either. On August 3, 2007, the German government announced that it would provide the necessary cash injection through KfW.

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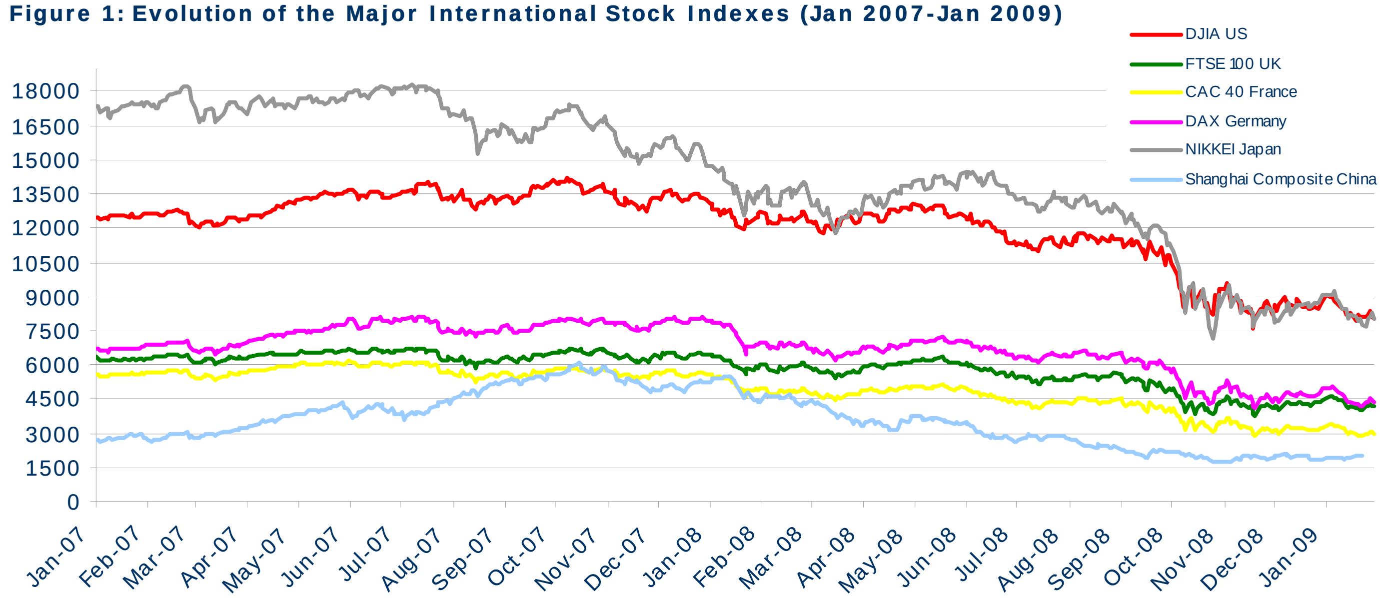
The same day that the ECB announced its emergency liquidity injection, BNP Paribas, a French bank with the most total assets in the Eurozone, declared that it could not value three of its funds worth a nominal €2 billion, due to the funds' sizeable exposure to U.S. subprime mortgages. After this, credit rating agencies downgraded many mortgage backed securities (MBS), forcing major U.S. financial houses to realize massive losses as they adjusted the valuations of their MBS holdings. Several banks needed heavy capital infusions to stay in business. In the last part of 2007 various sovereign wealth fund invested a total of more than $38 billion in equity the U.S. banks (IMF, 2008). Big problems remained though, as trading in MBS came to a virtual halt, even for AAA securities, and the short term borrowing options--which became the banks' main way of financing in 2007--were falling in volume and increasing in price. The spread between 30-day commercial paper and T-bills jumped to 365 basis points on August 28, 2007, after trading in a stable range between 25 and 50 basis points for many months. As a result, the Dow Jones Industrial Average (DJIA) slid from its July high of 14,000 points to a low 13,000 in August (Figure 1).

In August 2007, the ECB performed three money injections, of €95 billion, €61billion and €47.7billion. The United States and Japan took similar measures. The Fed cut rates at both scheduled and unscheduled meetings trying to inject liquidity into the system. The DJIA reacted quite positively, bouncing back to its 14,000 level in October 2007. In December 2007, the Fed created the "Term Auction Facility" that made 28-day loans to commercial banks and accepted AAA-rated MBSs as collateral, among other assets. Unfortunately, these responses turned out to be too little, too late.

The *annus horribilis* year 2008 brought over 30% drops to major stock market indexes around the world. It is considered the second worse outcome ever for U.S. investors, after the Great Depression. The year started with the highest levels of foreclosures ever recorded, in the face of which major mortgage lenders failed. Countrywide Financial Corp, America's largest mortgage lender, was rescued from bankruptcy through an acquisition by Bank of America for $4 billion. Northern Rock, the biggest mortgage lender in the United Kingdom, faced a similar liquidity squeeze linked to U.S. subprime mortgage problems and was nationalized in February 2008 (trading of shares is currently suspended). Bear Stearns was heavily exposed to mortgage-backed securities, which both

Figure 1: Evolution of the Major International Stock Indexes (Jan 2007-Jan 2009)



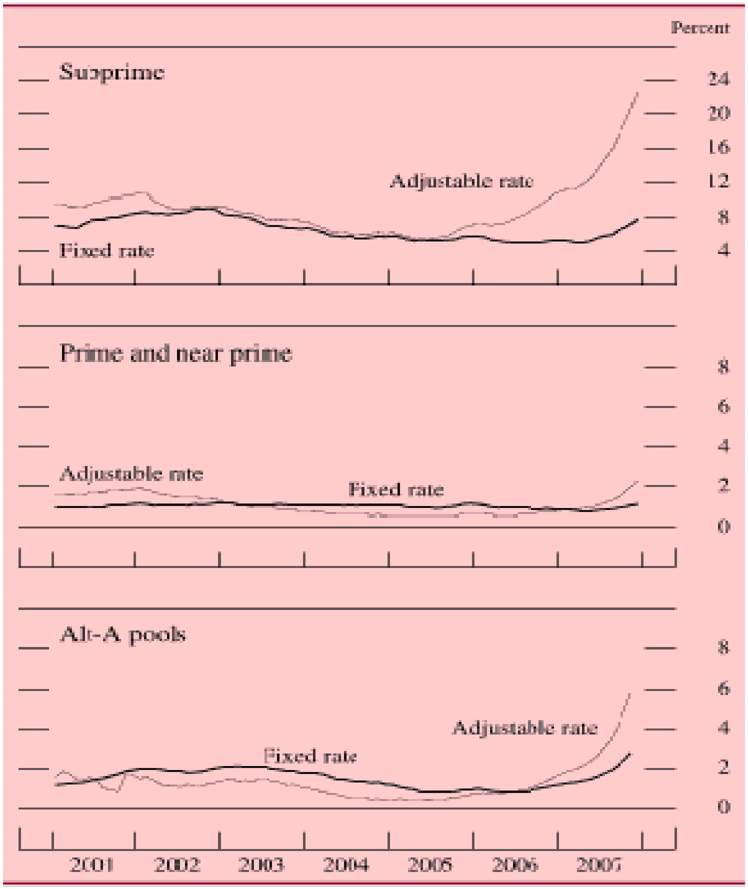
Source: Yahoo Finance

declined in value and became extremely difficult to trade. The firm had difficulty meeting margin calls due to a deteriorating liquidity position and was sold off to JPMorgan. The U.S. government facilitated the sale by shouldering $29 billion in potential losses from troubled assets. The DJIA, while trading at a significant discount to 2007 values, was still trading at levels that did not reflect the magnitude of the problem, closing at 12,292.66 in March 2008.
By the end of September 2008 everyone realized how serious the problem was and governments started creating plans to bring declining economies out of freefall. Before looking in detail at various bailout packages proposed by European, U.S. and other governments in response to these events, I discuss why these MBSs and collateralized debt obligations (CDOs) became so "toxic."

The development of the "subprime" and "credit" crisis

As of January 2009 over 40% of U.S. subprime mortgage loans are delinquent or in foreclosure. Fully 63% of subprime loans originated in 2007 are expected to default (Figure 2). Outlined below are the reasons that led to the decisions allowing these bad loans to be originated and created in such massive amounts. I then show how the risks of these mortgage loans were moved from the banks that underwrote them to a variety of other national and international institutions, as they purchased them in a form of MBSs.

Figure 2. Mortgage Delinquency Rates, 2001-07



Note: The data are monthly. For subprime, prime and near-prime mortgages, the data extend through December 2007; for mortgages in alt-A pools, w hich are a mix of prime, near-prime and subprime mortgages, the data extend through November 2007. Delinquency rate is the percent of loans ninety days or more past due or in foreclosure.

Source: First American LoanPerformance

I conclude with an explanation of practices that amplified the losses posed by the reduction in value of the MBS structured products. This knowledge about the history of the U.S. housing market allows a better understanding of the events that unfolded.

A "traditional" fixed 30-year mortgage with a stream of non-changing monthly payments became popular after WWII. Before the Great Depression, savings and loan associations (S&Ls) typically offered mortgages with no more than 12-year maturities and with constant interest payments and a balloon payment at the end. People refinanced the loans at maturity, but that became increasingly difficult during the Great Depression. The government's solution was to create the Home Owners Loan Corporation (HOLC) and borrowers received new mortgages based on the new assessment of their home values. S&Ls now were originating 30-year mortgages and holding them to maturity. They collected the interest off these longer term loans while financing them with short term deposits, on which they paid lower rates.

The maturity mismatch between rates paid and received was the main problem of the 1980's "S&L crisis." Short term interest rates rose sharply in the early 1980's, forcing half of the 32,234 S&Ls to fail, as the rates they were getting from their mortgage clients became lower than the rates they had to pay to depositors. In response, two government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, started to securitize the mortgages and sell them off as MBSs (mortgage backed securities).

Both Freddie and Fannie started out as government agencies but later became privately-owned and publicly traded companies. They bought bundles of mortgages from mortgage originators, repackaged them, and sold them off as mortgage backed securities. These securities delivered the payments on underlying mortgages to the holder. MBSs were securitized by GSEs, which meant that for a fee these agencies guaranteed the interest and principal on these loans. Given that GSEs remained solvent, the only risk that the holder of MBSs faced was prepayment risk (the risk that a mortgage will be paid off before it is due). Also, the loans that GSEs accepted for securitization had very strict guidelines in terms of loan size, down payment requirement (20%), borrower's income, and employment status and history checks were mandatory.

Before the 1990s, banks lent only to credit-worthy clients, due to rigorous GSE criteria. The 1990s brought a wave of new firms that lent money to borrowers who did not qualify for "prime" mortgages. These new lenders where acquired by Wall Street's big names, Bear Stearns, Lehman Brothers and, after 2006, by Morgan Stanley, Merrill Lynch, and Goldman Sachs. Countrywide, a company virtually unknown in the 1980s, became the largest mortgage lender in 2005. It served a variety of minority groups, thus reducing the FHA's (Federal Housing Administration—the agency that gave loans to people who did not fit GSE criteria) loan share significantly. Innovative loans that lessened previously strict GSE standards were created in order to make it easier for people to qualify. The need to prove income and employment was replaced by allowing "stated income" and "stated employment", the rules about down payment were relaxed due to "piggyback" mortgages (which covered the down payment on the first), smaller initial payments were possible due to "option ARMs" (adjustable rate mortgages). There was no precise distinction between "prime" and "subprime" loans, though the latter paid a higher interest rate. The interest rate a borrower paid was determined by a statistical model, where the main parameter was the borrower's credit score (FICO score). So-called 2/28 and 3/27 mortgages became popular because borrowers were told that after two or three years when the loan could be refinanced, they could get a lower rate, since they had time to improve their FICO score. Unsophisticated borrowers agreed to make payments they could not keep up with. Brokers who lent knew this, but they got paid for these deals which later left the bank's books and were sold off as MBS originated by new firms, like Countrywide and Washington Mutual. This "originate and distribute" banking system allowed banks to create loans using lax standards and then offload the risk.

The role of "private label" underwriters versus GSEs was growing in the MBS market. Only 28% of subprime loans were sold in the secondary market in 1995, but by 2005 it had climbed to 73%. About $500 billion in new MBS based on subprime loans were issued in both 2005 and 2006. Out of $11 trillion of total U.S. residential mortgages at the end of 2006 only $2.5 trillion were underwritten by GSEs (Chomsisengphet, 2006). Interestingly, GSEs were the major buyers of "private label" MBS, citing the low credit risk associated with those instruments, due to their high credit rating.

How could MBSs mainly created with subprime mortgages be so highly rated? When these collateralized debt obligations were created, a pool of loans was sliced into different tranches, each of which carried a different risk. The top tranches were the safest, as they were the first to pay out of the cash flows of the portfolio; therefore they carried the lowest interest rate and highest AAA rating. The lowest tranches, also referred to as "toxic waste," typically remained on the bank's books due to their low credit ratings. These riskier tranches paid the highest interest and were the most difficult to value due to infrequent trading. Both attributes may, however, have been favorable for some fund managers.

High credit ratings on senior and mezzanine tranches were supported by historically low mortgage default rates and low cross-regional correlation of housing prices. Favorable ratings were also accompanied by the fact that structured products paid higher fees and that issuers choose between Moody's, S&P and Fitch, rather than purchasing a rating from all three.

If buyers wanted more protection even on their AAA rated securities they could purchase CDS (credit default swaps). Credit-default swaps are insurance-like contracts in which a buyer makes regular payments to a seller, who in turn agrees to make a payout if a company or a particular CDO tranche defaults. AIG was one of the biggest underwriters of the CDS contracts sold in the United States and abroad. The notional value of the CDS market was over $60 trillion in 2008, but the actual netted value was much smaller. The CDS market lacked industry-wide rules and was traded through brokers, therefore remaining mainly opaque to the public and regulators. CDS trading amounted to 15% to 25% of top Wall Street firms' trading revenues, and the non-transparent trading environment allowed them to mark prices more favorably. Consider a $500 million position in an index of credit-default-swap contracts. A move of 0.01 percentage point, or one "basis point," typically can amount to a $460 gain or loss per $1 million traded. If an index moves 0.20 percentage point--as it can on especially volatile days--a trader's book could swing by $4.5 million (Ng 2008). In 2006, Markit created a set of ABX-HE indices that consisted of portfolios of credit default swaps. The standardization provided by these indices made it easy for financial institutions to predict the evolution of the subprime market as well as adjust their hedging based on individual risk profiles.

Structured financial products also allow risk to be spread among many market participants with different risk appetites. This leads to a positive outcome in a form of lower rates on loans, such as mortgages. Also, structured products allowed groups, such as pension funds, to indirectly hold assets they previously could not hold for regulatory reasons. While the structured instruments provided the market with the demanded risk-shifting product, most of the risk remained in the banking system. Major buyers were the investment banks, who typically hedged their exposure with CDS. However, a variety of pension funds and international, in particular European, banks purchased MBSs too and typically with a significantly reduced level of insurance in form of CDSs as compared to the investment banks. An interconnected web of local and foreign banks emerged as all of them were holding MBSs and a variety of them buying and selling insurance in forms of CDSs from the same sources, such as AIG.

Investment banks placed these MBSs into special purpose vehicles (SIVs), which were off-balance sheet entities. This move was motivated by a reduction in the amount of capital banks needed to hold to conform with Basel 1 (an international agreement that sets guidelines for bank regulations) capital standards. While there was an 8% capital requirement for holding loans on the balance sheet, there was no capital requirement for "reputational" credit lines, wherein a bank would move a pool of mortgage loans into off-balance sheet SIVs while granting them a line to credit. The risk for the bank remained unchanged, but it reduced the amount of capital needed to comply with Basel 1. This allowed for even more leverage in bank positions.

The nature of "where" firms looked for funds to increase their leverage was changing from long term bonds to shorter term instruments. The SIVs raised funds by selling short-term asset backed commercial paper, while the pool of mortgages was used as collateral. Just like during the "S&L crisis," the off-balance sheet vehicles invested in long term assets and collected higher interest and borrowed with short term instruments, paying lower rates. This maturity mismatch subjected the SIVs to funding risk as their strategy relied on easily available and cheap short term financing. To ensure liquidity, sponsoring banks provided "reputational" credit lines. So, the risk created by the maturity mismatch stayed in the banking system (Brunnermeier 2008).

Liquidity risk was increased by the bank's move to finance balance sheet items with short-term repurchase agreements (repos). In a repo, banks sell to another party a security at a specified price with a commitment to buy the security back at a later date for another specified price. The largest increases in repos outstanding came from overnight transactions which required banks to roll over funds daily. Low short term rates were made possible by "trusted" assets that were put up as collateral for repos and commercial paper. The trust in these assets depended on their credit ratings.

Banks carried a combination of high dependence on the liquidity of the short term financing and exposure to highly leveraged (30-1 or higher) longer term MBS. Therefore, if the valuations of MBS were to decline due to increasing defaults or foreclosures on the underlying mortgages, the banks would have difficulty covering the margin calls. The increasing defaults would create uncertainty about the correctness of credit ratings and structured product valuation. This uncertainty would reduce the willingness of counterparties to lend on a short term basis, as their confidence in assets used for collateral would diminish. The banks would be unable to roll over short-term commercial paper and their ability to borrow in the repo markets would decrease, therefore it would be hard to cover margin calls. They could try to raise funds by selling assets, however most banks had similar strategies and crowded sales would create high correlations across those strategies and push prices down. If foreclosure rates kept increasing, the confidence in MBS would decline even further as credit ratings would be questioned and reevaluated. The trading in these structured products would come to a halt, and it would become very difficult to value them. Banks would keep struggling to raise money as their customers, also troubled by the events, would start pulling their deposits out. The key for this hypothetical model is the increase in default rates that would push the value of MBS down and put in question high credit ratings. The defaults started increasing in reality in 2007 and brought this model all to much to life.

Quick summary of the reasons for the "subprime" and "credit" crises

The 1990s brought new companies that created exotic mortgages. Home ownership was encouraged by both the Clinton and Bush administrations, as indeed it had been by all administrations of the previous six decades. During the early years of the Bush Administration, the U.S. Federal Reserve followed an expansionary monetary policy, which kept interest rates low due to the fear of deflation after the technology bubble burst and the 9-11 terrorist attacks. All of the sudden, Americans were encouraged to borrow extensively, and it was cheap to do so--as the rates were low--and very easy for anyone to do, as the loan requirements were significantly eased. Easy access to capital and the decline in mortgage standards allowed people to purchase houses they were not actually able to afford, which led to a dramatic increase in personal leverage. Increasing loan volumes were encouraged by the high compensation that underwriters received. However, the mortgage originators did not retain these questionable loans on their books as they were repackaged, securitized, and sold off as MBSs. This originate-and-distribute model allowed banks to offload risk. It separated the originators from the eventual holders of the loans as financial institutions repackaged these mortgages and traded them with high (30-1) leverage. So, both people and banks had little equity in the game but kept making serious money due to inflated housing pricing. The leverage was transitioning from the original sources, such as long term bonds, to instruments with shorter maturities, such as commercial paper and repos. Financial institutions were collecting the higher interest paid by mortgages in their MBS while sponsoring them with cheap short-term assets. There was an apparent maturity mismatch that depended heavily on the liquidity and availability of short term financing. MBSs and CDOs lacked transparency as they were placed in off-balance sheet entities, such as SIVs. Meanwhile, the fear of inflation, based among other factors on the doubling of home prices, caused the Fed to start raising rates in mid-2004, until these reached 5.25% in September 2006. Monthly payments on the loans that had to be refinanced rose, forcing many borrowers to default. In spring of 2007 Moody's started a review of U.S. subprime deals, which quickly prompted a series of ratings downgrades. Companies took massive losses on their MBS positions, and it became increasingly difficult to price these securities as their trading slowed due to market uncertainty about the structured products' valuations. Counterparties lost trust in each other and stopped lending to other institutions in the short term market, which banks relied on heavily. The other positions that banks held declined in value as global stock markets dropped, reflecting investor panic. Banks were faced with margin calls on their highly leveraged positions, at the same time that it was hard for the financial institutions to find financing. So the governments stepped in to offer even higher access to money than before, some of it in exchange for the partial ownership of the companies.

Government reactions

Even before the official bailout plans were announced in October 2008, governments started taking stakes in banks in order to prevent the crisis from spreading. In March 2008, the Fed agreed to take $29 billion of potential losses from Bear Stearns' illiquid assets, as it helped facilitate the sale of Bear Stearns to JP Morgan. In July, IndyMac was seized by federal regulators and at the time was seen as one of the largest U.S. bank failures. Freddie Mac and Fannie Mae had been posting steep losses, along with AIG, and on September 8 the government performed the most dramatic market intervention in years by seizing Fannie Mae and Freddie Mac.

The rest of September 2008 brought the most dramatic and nearly unimaginable events. Due to massive losses on its subprime loans, the firm's inability to borrow due to illiquidity in the short-term commercial paper market, and its failure to meet margin calls on highly leveraged positions, Lehman Brothers announced bankruptcy. That same day Merrill Lynch was purchased by Bank of America for $50 billion. Somewhat later, Barclays announced that it was buying a stripped-down Lehman North America for $1.75 billion. AIG, an insurer that underwrote many CDSs and sold them nationally and internationally, was struggling as it had to unexpectedly pay out on the Lehman default. The firm had difficulties meeting margin calls as the price of insurance they sold skyrocketed. The Fed decided that AIG was too interconnected and too big to fail and seized control of the insurance company in what would later become a $123 billion bailout, which involved a government receipt of $40 billion of preferred stock. In October 2008, the government announced that it would invest $250 billion of the $700 bailout package in top banks and thousands of others in a partial nationalization of the finance sector that mirrored the British plan. The following week nine of the largest U.S. financial institutions, holding 55% of U.S. banking assets signed up to sell $125 billion in preferred stock to the Treasury.

The last independent investment banks, Goldman Sacks and Morgan Stanley, were converted into traditional bank holding companies at the end of September 2008. The U.S. Fed, the ECB (European Central Bank), the Bank of England, and the Swiss National Bank all said they would lend as much liquidity to financial firms as needed. The Fed promised to lend directly to corporations for the first time since the Great Depression. In addition, in November 2008 the U.S. pledged to pump additional $800 billion into the credit markets, while planning to buy around $600 billion of debt issued by mortgage finance firms, such as Freddie and Fannie. That same month the government guaranteed more than $300 billion in troubled assets on Citigroup's books. In December 2008 the Fed cut its target rate to a historic low of between zero and 0.25 percent, and also committed $6 billion to stabilize GMAC (a financing company vital to the future of General Motors) in exchange for 5% of GMAC's preferred stock. Many experts predicted that these government actions and promises of continued support would ease investors' fears. The majority of analysts was also predicting gains for the U.S. stock market in December 2008, but once again was proven incorrect in their assessment of the depth of the problem. The DJIA declined and ended 2008 at 8776.39, a 33.8% drop for the year and the worst since 1931. Oil closed at $44.6 per barrel, 53.5% down from the high of $145.29. So, at the end of 2008, nearly 314 institutions had already signed over some of their mainly preferred shares and other securities to the Treasury in return for $350 billion in government aid.

Government actions in Europe and Asia

In late 2008, **Britain**'s Prime Minister Gordon Brown announced that his government's stimulus plan would cost more than £500 billion, and that the government might be forced to nationalize the three largest U.K. banks (HSBC, RBS, Lloyds TSB) through equity purchases, after already posting a £37(S53.48) billion injection. The government is expected to take a shareholding of 50% or more in RBS and 43% in the combined Lloyds TSB and HBOS (the country's largest mortgage lender). Northern Rock and Bradford and Bingley were nationalized earlier in 2008. Total U.K. bank assets jumped from two times GDP in 2001 to almost 4.5 times by 2008. According to a report by London-based Smithers & Co, the median leverage of U.K. banks reached 33:1 in 2008, ranging from 18 to 60. These hedge-fund levels of leverage throughout the British banking system are immensely dangerous for British solvency.

France announced that it would guarantee up to €320 billion in inter-bank loans and provide €40 billion in new capital for banks by purchasing their equity.

After encouragements to seek private investors did not work, **Ireland** decided to pump $7.7 billion into its three largest banks. The Irish government also took control of Anglo Irish Bank, receiving 75% of voting shares for its $2.09 billion injection. Allied Irish Bank and Bank of Ireland will each get $2.78 billion.

Switzerland's bank rescue plan involved a familiar combination of new equity and guarantees of bank debt. What made their plan different from the British and French (equity purchase) plans and the U.S. (preferred stock purchase) plan was the reduced role of the government. The Swiss bank UBS issued $5.3 billion of new equity in the form of a mandatory convertible bond. The conversion would occur only after 30 months, which would give the government plenty of time to exit.

Japan was one of the first to announce a $106 billion stimulus package at the end of August 2008. By October it had already injected $45 billion. China announced its $586 billion bailout plan in the middle of November 2008, while South Korea said in December 2008 that it will create a $15 billion fund to help banks lend to businesses in need of cash.

Germany took a 25% stake in Commerzbank AG, after agreeing to spend another €10billion to shore up finances of the country's second largest bank. German authorities are taking an aggressive approach to strengthening the country's financial system, after hesitating before launching a €500 billion bank-bailout fund last autumn. IKB is receiving €5billion ($7) in debt covering, while NordLB is receiving a state guarantee for up to five years.

Russia suffered a major currency devaluation with the ruble loosing 1/3 of its value. Russian companies need to refinance $140 billion in foreign debt in 2009. The Russian state development bank, Vneshekonombank (VEB) announced on October 29, 2008 that it had approved loans of $10 billion to several Russian companies, as a first tranche of assistance under the government's $50 billion bailout package. Aluminum giant Rusal will be given $4.5 billion, secured against a 25% stake in nickel giant Norilsk Nickel. Alfa Group will receive $2 billion against a 44% stake in mobile phone operator Vimpelcom. The Russian government announced that it had no intention of extending the state's ownership, however some of the shares pledged as collateral would go to the government if the companies tapping the $50 billion package would be unable to repay the loans next year. As of January 2009 an

$11 billion injection into its state-owned banks was approved in order to increase lending. However, it will be a difficult objective to reach as Russian companies stopped paying on salaries and loans and instead are putting on a dollar trade. It is cheaper for them to pay the 36% penalty on ruble loans and invest the money instead into the dollar, while stashing away the hard currency on their books.
The **Dutch** government promised up to €200 billion in guarantees for interbank loans to temper the credit crisis in October 2008. The Netherlands bought Fortis for $23 billion to avert a liquidity crisis, but Fortis shareholders are seeking a renegotiation on the sale of assets ($19.1 billion) to BNP Paribas, a French bank, and are planning to take legal steps against the Dutch state over its nationalization of the bank. The Netherlands and Austria had difficulty raising money in their bond auctions in December 2008.

The **Spanish** state guaranteed €200 billion of inter-bank lending and approved €30-50 billion for buying assets from banks. Spain will also provide up to €100 billion of guarantees for new debt issued by commercial banks in 2008 and an unspecified amount for 2009. Italy is allocating €20 billion to buy into banks unable to weather the global financial crisis. The Netherlands, Spain, Italy, Austria, Portugal and Norway total commitments for bank capital and guarantees added up to a bit over €500 billion.

The **Indian** finance minister, Palaniappan Chidambaram pledged to inject as much emergency funds as needed to keep India's financial system functioning.
Canada announced plans to purchase $25 billion in high-quality mortgages from banks in an attempt to improve their lending abilities.

Finally, **Australia**, **New Zealand** and the **United Arab Emirates** announced guarantees for all bank deposits.

Future Trends

US output contracted by an annualized 3.8% in the fourth quarter of 2009, Euro-Zone economy shrank by an annualized 5.9%, while Japan announced a 12.7% decline. In the first quarter of 2009 economists became more bearish on the U.S. outlook, revising down the GDP forecasts—from 1.2% increase in the first three month of 2009 to 4.6% decline and from 1.9% growth in the second quarter to 1.5% decline. While the third and fourth quarters are predicted to show growth, the scale is much lower than predicted before. The picture looked much worse for the U.K. with sharply lower estimates of their economic shrinkage -- 3.3% in 2009 and no growth in 2010. Russian industrial production plunged in January, falling by a massive 16% in December 2008 from a year earlier. That is nearly triple the pace of contraction the government and Rosstat (Federal Statistics Service) have forecast. These reductions in GDP are followed by increases in unemployment. The U.S. unemployment rate is expected to climb more than 1% to a 8.8% level by December 2009. Euro-Zone countries will experience a similar, if not worse, unemployment spikes.

These factors could signal that the market has not yet "reached the bottom." While the U.S., European and Asian governments have increased liquidity through lending, banks can face more losses until the fundamental problems that caused the housing gluttony are resolved. There is a variety of interconnected factors that caused the problem with the core lying in the diminished self-control of bankers, consumers and general market participants, which is difficult to fix. The solution will require restoration of business and consumer confidence and re-establishment of valid business controls in large organizations, in particular,

banks. Partial improvement can come from more stable housing prices and foreclosure rates, which in turn will help estimate better values for MBSs and restart their trading in that market again. However, given the current economic outlook it is hard to predict when we will see this needed level of stability.
Higher unemployment and declining GDP along with decreased exports and reduced spending will increase the businesses' need for loans as they strive to survive. More aid is likely to be offered in the form of government programs. America is leading the increase in government spending with an approval of an additional $789 billion stimulus plan in February 2009. This, of course, is an addition to the $700 billion bailout package described above. The long term effects of increased government spending and its help in recovery from this recession seem uncertain. Government programs will take time to show the outcomes they are designed to achieve but initial effects are questionable, especially in the areas of loan volume, effect on banks who did not apply for the funds and bankers' pay. Largest U.S. banks, which received $148 billion in taxpayer money through TARP, reported that lending declined 1.4%, or about $45 billion, between third and fourth quarters of 2008. This shows that new loans for business expansion are not being originated, which was the main purpose of TARP. But very little time has passed since TARP funds were made available to banks and it takes time to make prudent loans. Besides TARP not generating result in loan volumes that it hoped for, it is sometimes blamed for reducing confidence in banks that did not need TARP funds. Investors are moving funds from institutions that did not need a government rescue to banks that got federal help. Banks that received capital injections from the Treasury are benefiting from an implied U.S. government guarantee; even though some of them bore responsibility for lending practices that helped produce the global financial crisis. There is no published data on which banks applied for funds and were rejected based on poor performance. So, investors question the performance of all banks that did not get government support, as they do not know if the banks applied and were rejected or never applied. Another question that has surfaced deals with the effect of capped bankers' bonuses in partially nationalized banks and their performance. Lower pay might discourage CEOs from working on solutions that require better risk management and instead push them towards making their banks even bigger and more interconnected, in order to classify for the next bailout. However, if bankers succeed in restructuring their businesses, then in the long run taxpayers, who are the end sponsors of all government spending, will benefit when these nationalized institutions will be re-privatized.

Increased market transparency for structured products is another benefit this market downturn brings. Through Mark-it and the Depository Trust and Clearing Corporation (DTCC) the U.S. has created a clearing system for credit default swaps (CDS). Outstanding notional and netted CDS positions are now posted online. Europe is actively working on forming a clearing system for the huge CDS market.

While a lot of uncertainty remains on how long the recession is going to last and what the long-term effects of government actions will be, they proved somewhat successful in the short term. The short-term lending rates returned to reasonable levels, banks have access to liquidity and home sales seem to be showing signs of recovery. More government support will probably be extended in 2009 and more than likely partial nationalizations of banks will continue. This year will allow us to follow this process of confidence restoration further and hopefully allow countries to move forward while remembering the lessons learned.

Appendix 1: 2008 Timeline[i]

APRIL

1 The Bush administration outlines a sweeping plan to streamline the US financial-regulatory system, with proposals to consolidate bank regulation, create a new type of insurance charter, improve the oversight of mortgage lending and allow the Fed to peek into more corners of finance. Criticism from small banks, state officials and others presages a long fight.

The Dow industrials end March down 7.6% from the start of the year, at 12262.89, marking their worst quarter in 5½ years.

3 The Fed has set up shop inside brokerage firms to monitor their financial condition, the first such move in more than a decade.

Merrill Lynch posts a $1.96 billion loss on $6.6 billion in write-downs. The Wall Street firm says it is cutting 4,000 jobs.

19 Citigroup posts a $5.1 billion quarterly loss as earnings in its main businesses fall.

30 Countrywide Financial posts an $893 million loss as a federal probe is finding that sales executives at the mortgage lender deliberately overlooked inflated income figures for borrowers.

MAY

1 The Fed cuts its key interest rate by a quarter point to 2%, the seventh cut in eight months, but signals that it may be ready for a pause as steps taken to lubricate financial markets have reduced the risk of a severe recession.

30 Treasury securities are in their worst selloff in months as investors, worried about inflation, shift to riskier assets.

JUNE

2 The number of foreclosed homes owned by lenders continues to rise despite signs they are increasingly willing to cut prices.

9 The average US price of gasoline hits $4 a gallon for the first time. Gasoline prices are up 29% over the past year, straining household

17 Lehman Brothers Holdings posts a $2.8 billion quarterly loss, and its CEO insists the firm can "go it alone" without a big bank as a partner. A few days earlier saw Lehman replacing its president and its chief financial officer as the investment bank dealt with a credibility crisis with investors.

26 The Fed keeps its key short-term interest rate at 2%, expressing heightened concern about inflation. It is the first time since the credit crisis flared in August 2007 that the central bank doesn't cut rates.

JULY

12 IndyMac is seized by federal regulators in one of the US's largest bank failures. Regulators' search for a buyer continued through the rest of the year.

14 The Treasury and Federal Reserve seek to shore up confidence in Fannie Mae and Freddie Mac by announcing a plan that places the government firmly behind the mortgage giants.

16 The Securities and Exchange Commission says it will move to curb short-selling in the stocks of Fannie Mae and Freddie Mac, as well as in 17 financial firms.

AUGUST

7 Freddie Mac posts an $821 million loss and warns of further losses for 2008. Its shares drop 19%. Insurer AIG reports a $5.4 billion loss as the housing market continues to pose problems.

31 Japan unveils a $106 billion economic-stimulus package that includes tax cuts and loan guarantees.

SEPTEMBER

8 The government seizes Fannie Mae and Freddie Mac in its most dramatic market intervention in years. The Treasury plans to replace the mortgage giants' CEOs and buy $1 billion of preferred shares in each without providing immediate cash. The takeover isn't expected to cure falling home prices and rising foreclosures, Economists say.

15 Wall Street is shaken to its core in a frenetic Sunday: Lehman faces the possibility of liquidation, and Merrill Lynch agrees to be sold to Bank of America in a $50 billion deal. Meanwhile, AIG seeks to raise cash and craft a survival plan amid investor pressure.

16 The Dow industrials fall 504.48 points, or 4.4%, to 10917.51, the lowest close in more than two years. Oil falls 5.4% to $95.71, the first close below $100 since March.

17 The US seizes control of AIG. The bailout is a turnabout for the US and signals concerns about the danger that AIG's collapse could pose to the financial system.

Barclays agrees to acquire the bulk of Lehman for $1.75 billion, buying a stripped-clean version of the firm's North American business.

22 The Fed takes the extraordinary step of agreeing to convert the last two major investment banks, Morgan Stanley and Goldman Sachs Group, into traditional bank-holding companies under the close supervision of national bank regulators. With the move, the Wall Street model of independent brokerage firms will cease to exist.

24 Goldman Sachs is getting a $5 billion investment from Warren Buffett, marking one of the biggest expressions of confidence in the financial system.

26 Federal regulators seize Washington Mutual and strike a deal to sell the bulk of its operations to J.P. Morgan in the largest bank failure in US history.

29 Fortis receives a $16.37 billion injection from the Netherlands, Belgium and Luxembourg. On Oct. 4, the Netherlands says it will buy most of Fortis for $23 billion.

30 The House defeats the Bush administration's $700 billion rescue package. The Dow industrials plunge 777.68 points, or 7%, to 10365.45, as fears grow that more banks could fail. Oil falls $10.52 to $96.37 a barrel.

Citigroup agrees to acquire most of Wachovia for nearly $2 billion in a US-engineered takeover. Four days later, Wells Fargo makes a higher offer that doesn't hinge on government support. On Dec. 23, Wells Fargo and Wachovia shareholders approve Wells Fargo's $11.8 billion purchase.

OCTOBER

1 The Dow industrials surge 485.21, or 4.7%, to 10850.66 but end the third quarter down 4.4%.

4 President Bush signs into law a $700 billion plan to rescue the US financial system, one of the largest-ever government interventions in the economy.

7 The Dow industrials fall 369.88, or 3.6%, to 9955.50, the first close below 10000 in nearly four years. European stocks post their biggest drop in 20 years.

8 The Fed says it will bypass ailing banks and lend directly to US corporations for the first time since the Great Depression.

9 The world's central banks launch a coordinated attack against the widening global financial crisis, lowering short-term rates in unison by a half-percentage point.

10 The Dow industrials plunge 678.91, or 7.3%, to 8579.19, falling for the seventh straight day, or more than 20% over that stretch.

11 Mitsubishi UFJ Financial Group injects $9 billion into Morgan Stanley
The Fed says it will lend as much as $540 billion to the money- market mutual-fund industry.
30 The Fed cuts its benchmark rate by a half-point to 1%, the lowest level since 2003-04; two other central banks do likewise.

NOVEMBER
1 The Dow industrials rise 144.32, or 1.6%, to 9325.01 but still end October down 14%, the worst month in percentage terms in more than 10 years. October proves to be a washout for commodities as oil drops 33%, its worst one-month loss in history.
10 The government reaches a deal on a Sunday night to scrap its original $123 billion bailout of AIG and replace it with a $150 billion package of considerably less onerous terms on the insurer.
China announces a $586 billion stimulus package that could bolster domestic demand and help revive dependent economies.
The US begins its fiscal year with a record $237.2 billion budget deficit in October, reflecting bailout spending.
15 Freddie Mac posts a $25.3 billion loss and says it will need a $13.8 billion cash infusion as losses stemming from home-mortgage defaults surge.

Table 1. Financial Sector Rescue Efforts by the U.S. Federal Government (Dec 2007 - Jan 2009)

Date	**Bailout**	**Allocated (bn. US$)**	**Spent (bn. US$)**
Dec-07	Term Auction Facility	2.100,00	2.100,00
Feb-08	Economics Stimulus Act of 2008	168,00	168,00
Mar-08	Bear Stearns bailout	29,00	25,80
Mar-08	Discount window	n/a	99,80
May-08	Student loan guarantees	130,00	9,00
Jul-09	Indy Mac is nationalized		
Sep-08	Fannie Mae and Freddie Mac bailout	200,00	13,80
Sep-08	Foreign exchange dollar swaps	Unlimited	387,40
Oct-08	FHA housing rescue	320,00	20+
Oct-08	Auto industry energy efficiency loans	25,00	0,00
Oct-08	Troubled Assets Relief Program (TARP)	700,00	296,20
Oct-08	*PNC (Pennsylvania sells $7.7bn preferred stock)*		
Nov-08	*AIG capital investment*	*40,00*	*40,00*
Oct-08	*Bank capital investments 1*	*20,00*	*195,30*
Nov-08	*Citigroup capital investment*	*20,00*	*20,00*
Nov-08	*Citigroup loan loss backstop*	*5,00*	*0,00*
Nov-08	*TALF loss provisions*	*20,00*	*0,00*
Dec-08	*Auto industry bailout 1*	*24,90*	*20,00*
Jan-09	*Bank of American capital investment*	*20,00*	*20,00*
Oct-08	Money market guarantees	659,00	15,00
Oct-08	Commercial Paper Funding Facility	1.400,00	258,70
Nov-08	Unemployment benefit extenstions	8,00	8,00
Nov-08	AIG	152,50	125,10
Nov-08	*Treasury capital investment*	*40,00*	*40,00*
Nov-08	*Bridge loan*	*60,00*	*38,60*
Nov-08	*Collateralized debt obligation purchases*	*30,00*	*27,50*
Nov-08	*Mortgage-backed securities purchases*	*22,50*	*19,00*
Nov-08	Citigroup loan-loss backstop	301,00	0,00
Nov-08	Term Asset-Backed Securities Loan Facility	200,00	0,00
Nov-08	GSE mortgage-backed securities purchases	500,00	7,40
Nov-08	GSE debt purchases	100,00	29,90
Nov-08	FDIC Temporary Liquidity Guarantee Program	1.500,00	258,00
2008	FDIC bank takeovers 1	n/a	16,70
Jan-09	Bank of America loan-loss backstop	118,00	0,00
Jan-09	Credit Union deposit insurance guarantees	80,00	0,00
Jan-09	US Central Federal Credit Union capital injection	1,00	0,00
2009	FDIC bank takeovers 1	n/a	920,10
Total		8.691,50	4.758,90

Source: The majority of this information came from the CNNMoney Special Report
http://money.cnn.com/news/specials/storysupplement/bailout_scorecard/index.html

24 The government agrees to take unprecedented steps to stabilize Citigroup, guaranteeing more than $300 billion in troubled assets weighing on the bank's books and injecting an additional $20 billion in capital into the company.
26 The US pledges to pump another $800 billion into ailing credit markets, much of it directly from the Fed. The central bank plans to buy up to $600 billion of debt issued or backed by mortgage-finance firms such as Fannie and Freddie. With support from the Treasury, the Fed

DECEMBER
2 The recession began last December, the National Bureau of Economic Research says.
Crude-oil futures sink 6.6% to $40.81 a barrel, down 25% for the week.
The US loses half a million jobs in November, the largest monthly drop in 34 years, pushing the unemployment rate to 6.7%, a 15-year high.
10 The Treasury sells four-week notes at a 0% yield for the first time, with investors in effect giving up their cash for safe-keeping until 2009.
17 The Fed cuts its target interest rate to historic lows between zero and a quarter percentage point and says it could expand a program of unorthodox lending and securities purchases as it seeks to lift the US out of recession. Central banks around the world cut rates the next day.
The benchmark 30-year fixed-rate home mortgage falls to a national average of 5.17%, the lowest since Freddie Mac began its survey in 1971.
30 The government commits $6 billion to stabilize GMAC, a financing company vital to the future of General Motors.
31 The Dow industrials rise 108 points, or 1.3%, to end at 8776.39 -- a fall of 33.8% for the year, the worst drop in percentage terms since 1931 and third worst in the DJIA's history. The year's 4,488.43- point drop is the worst ever. The Nasdaq finishes at 1577.03, down 1,075.25 points, or 40.5%, for the year. The S&P 500 ends at 903.25, down 565.11 points, or 38.5%, for 2008. Oil settles at $44.60 a barrel, down 53.5% for 2008, after closing in a range from $33.87 to $145.29.

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Are We on the Brink of a Re-Privatization Wave in Latin America?

Introduction

During the 1990s, Latin America was a leader in privatization transactions. Between 1990 and 2001, it accounted for 47 percent (or $361 billion) of all investments in infrastructure projects in developing countries (Harris 2003:6). Likewise, in terms of proceeds, Latin America far outpaced other developing areas, netting an estimated $178 billion between 1990 and 1999 (Chong and López de Silanes 2004:43). In the 1990s, Latin America also pioneered a wide variety of state divestiture strategies, which made it a point of reference for other developing countries in other parts of the world attempting privatization policies. There is also enough empirical evidence suggesting that privatization not only had a positive impact on profitability, output, productivity (Chong and López de Silanes 2004), employment (La Porta and López-de-Silanes 1999; Kikeri and Nellis 2002; López-Calva and Rosellón 2002), government taxes/fiscal balance (Davis et al. 2000), and prices (McKenzie and Mookherjee 2003), but also on the social welfare of the poor by providing access to basic services.

These positive results notwithstanding, by the mid-2000s the privatization of utilities was out of favor. As Nellis (2006:1), pointed out, “Contrary to popular conception, privatization has not contributed to maldistribution of income or increased poverty—at least in the best –studied Latin American cases. Nonetheless, public opinion in the less developed world is generally suspicious of, and hostile to, privatization.” Protests have been particularly common against the private provision of public services in several Latin American countries, leading to the cancellation or renegotiation of existing contracts in Argentina, Bolivia, the Dominican Republic, and Mexico. Ironically, some of these privatizations had had been regarded as best practice cases only a few years earlier (Reel 2006). These events confirmed previous findings from the Latinobarometro opinion polls which, since 1998, showed that the majority of respondents across Latin America disapproved of privatization. The negative trend reached its peak in 2003 when only 22 percent had a positive opinion about state divestiture (Latinobarometro 2007). Public opinion slowly improved after then but, by 2007, the Latin American average still showed that only 35 percent of respondents believed that privatization had been beneficial to their country. After 2000, public opinion’s negative assessment of privatization also mirrored a sharp decline in private investments and widespread pessimism among investors about the future of new infrastructure projects in the region.

In Latin America, these negative trends coincided in the 2000s with the coming to power of a new brand of populist presidents who capitalized on popular dissatisfaction with market reforms in general, and privatization in particular. Using a left-wing rhetoric Hugo Chavez (Venezuela), Nestor Kirchner (Argentina), and Evo Morales (Bolivia) proceeded to re-nationalize key industries that had been previously privatized or renegotiating/cancelling existing concession contracts (Romero 2008). These three leaders seem to symbolize a return to heavy government regulation and economic nationalism, which dominated Latin America from the 1950s until the late 1980s (Haslam 2007). Their initiatives have created widespread speculations that, given the unpopularity of market oriented policies, more Latin American leaders would follow a similar path. Indeed, 2006 saw the emergence in crucial presidential elections in the region of many left-wing populist candidates, some of whom had close ties with Chavez, who campaigned on platforms attacking market reforms and foreign investments. However, the results of such elections were mixed. Whereas Andrés Manuel López Obrador in Mexico and Ollanta Humala in Peru suffered close losses, Rafael Correas in Ecuador, and Daniel Ortega in Nicaragua, scored clear victories. The situation has become worrisome enough that in his review of private infrastructures a well know expert warned that the "politics of reform is challenging and some countries may see a longer-term reversal to public provision" Harris (2003:2).

This paper constitutes a preliminary attempt to assess why in Latin America public opinion turned against private privatization and what the chances are of a re-nationalization of utility infrastructures. In the part I will assess the strength of three general theses that pundits and academics have recently put forward to explain why the public has turned against privatization in Latin America:

a) Latin American citizens have embraced left wing ideologies, which reject market reforms in general, and privatization in particular;

b) The economic crisis of the early 2000s has negatively affected people's evaluation of privatization; and

c) Popular evaluations of privatization have been affected by perceived corruption.

In the second part I will discuss whether the recent trends in Venezuela, Bolivia, and Argentina are likely to expand to the rest of Latin America or are dictated by business cycles peculiar to such countries. Put it differently; are we on the verge of a reversal of privatization and market reforms in the region as some people fear?

Why Are Latin Americans Unhappy about Privatization?

In the introduction I have briefly described the background behind the current unpopularity of market reforms in Latin America., and in particular privatization. Often times, a combination of such factors has contributed to the widespread public perception that the divestiture process has produced negative consequences, even though several studies, both at the national and cross-national level, point to significant service improvements. I have also underscored in the previous analysis how such factors have been instrumental in allowing governments, which were elected well after major utility privatizations had been completed, to engage in opportunistic behavior. Where the economic crisis has been most acute and privatization benefits highly disputed, populist politicians in Argentina, Bolivia, Ecuador, and Venezuela have exploited the situation by promising a return to economic nationalism and a reversal of the privatization policies of the 1990s.

In the second part of the paper my goal is to understand the determinants of such a dramatic shift, which so far has affected a handful of Latin American countries. Is this shift dictated by a dramatic political reorientation of the Latin American voters toward Marxism-Socialism, a thesis that some commentators have recently embraced (Zibechi 2006; BBC 2006). Alternatively, are negative public opinion trends more the end result of unfavorable economic trends, and/or public disgust with the corruption associated with utility privatization? I will now examine these three contending theses accordingly.

Thesis one: Latin Americans have moved to the Left. The coming to power of fiery presidents like Chavez, Morales, Kirchner, Correa, and more recently Ortega, all of whom espouse a brand of populism with strong-left wing-overtones, has led some pundits to speculate that the failure of market reforms has created a breeding ground for the emergence of a new left in Latin America, which these presidents well represent (Gradin 2006). However, once we take a closer look at the phenomenon, we notice that presidents who have ideologically committed to socialism like Brazil's Luiz Inácio Lula da Silva (commonly dubbed as Lula), Chile's Michele Bachelet, and Uruguay's Tabaré Vázquez, have been much more moderate in their economic policy-making (Castañeda 2006: Schamis 2006). In point of fact, both Lula and Bachelet have continued the free market policies inherited from their predecessors, while trying new social programs to reduce income inequalities.

These trends present a puzzle. If the "popular shift to the left thesis" were correct, we should see socialists, more so than populist presidents, attacking market reforms and reneging/renegotiating privatization deals. According to the Latinobarometro surveys (2007), between 1996-2007 most people in Latin America identified themselves as centrist. Although variations exist across countries, the number of extremists remained fairly stable, and relatively small throughout the period. What is also interesting is that in Venezuela, Bolivia, and Argentina, the number of left-wing extremists has grown very little and remains confined to a very small segment of the population. The findings Latinobarometro (2007) findings not only show that the bulk of Latin Americans consider themselves as centrists but that, overall, there are almost twice as many conservatives as left-wingers.

Thus, the anti-market moves that have characterized Chavez, Morales, and Kirchner may respond to their intention to capitalize on popular dissatisfaction about the way market reforms have performed rather than to their eagerness of leading the growing numbers of left-wing voters in their respective countries. An indication that political opportunism may be at the heart of these presidents' recent policies comes from Kirchner's track record. When in the early 1990s he was governor of the oil and gas rich province of Santa Cruz, Kirchner played a major role in convincing fellow governors to approve President Carlos Menem's privatization of the Argentine oil company Yacimientos Petroliferos Fiscales, in exchange for large royalties. Prior to being elected president in 2003, Kirchner never gave any sign of being opposed to market reforms, including privatization. As for Morales, his socialist rhetoric seems to be grounded into the communitarian culture of the native people of Bolivia, which voted overwhelmingly for him, rather than a true ideology. In fact, according to the Latinobarometro (2007) , no more than 10 percent of Bolivians, on average, have identified themselves as left leaning. In brief, the fact that populist, rather than socialist presidents, have nationalized utility infrastructures or forced major contract renegotiations to their advantage, seems to respond to political opportunism, not a major shift to socialist policies.

Thesis Two: Economic Crisis. A second popular thesis interprets the negative change in public opinion to the business cycle, as it was described earlier in this paper. Put differently, people ascribe to market reforms the fact that their countries either experienced poor economic growth (and in some cases, major financial crises) between the late 1990s and the first half of the 2000s.

Panizza and Yañez (2006) argue that it is indeed the collapse in economic activity at the turn of the 21st century in most of Latin America which explains the popular backlash against reforms. In articulating their thesis, Panizza and Yañez (2006) demonstrated how major economic variables deteriorated appreciably after 1997. Save for inflation, the output gap, unemployment, and the depth of the crisis all point to a sharp deterioration by 2002. Table 1 reports the results of Panizza and Yañez's regression analysis, which tries to determine the impact of economic variables on public opinion based upon Latinobarometro surveys. The dependent variables are attitudes toward privatization and the market economy. The economic variables are lagged by one year, and the control variables include age, sex, and wealth (in quintiles). The results generally confirm the business cycle thesis, even though unemployment is not statistically significant when all the economic variables are entered simultaneously in the equation. In commenting on their results, Panizza and Yañez (2006:11) remark:

"If we look at the relationship between the output gap and the support for privatization during the 1998-2003 period, we can see that support for privatization went from 52 to 25 percent. The average output gap was 3 percent in 1997, and – 3 percent in 2002 (a change of 6 percentage points). By multiplying 6 by the estimated coefficient (0.012), we obtain 0.072, which is close to one third of the total drop in support for reforms. The case of Argentina is a striking example of the importance of macroeconomic factors. In this country, the output gap went from 7 in 1997 percent to -14 percent in 2002. This also explains a drop in support for privatization equivalent to 25 percentage points, which is about 80 percent of the observed drop in support for privatization in Argentina (which fell from 45 to 13 percent)."

These are fairly robust results and, intuitively, make a lot of sense. However, Panizza and Yañez's model does not account for unobserved characteristics linked to the ideological orientation of individuals, present and future economic situations. Thus, their findings must be interpreted with caution.

Thesis three: Corruption and lack of transparency. It is precisely the incompleteness of Panizza and Yañez's model, which brings us to the next thesis: the importance of corruption and lack of transparency in determining negative attitudes about privatization. As noted earlier, according to Martimort and Straub (2006), the most important reason determining the unpopularity of privatization stems from the public perception that state divestiture fueled corrupt deals between companies and government officials at the expense of consumers in the form of high utility rates due to cost-through charged to customers. In fact, suspicion of corruption was not just limited to the initial transfer/or concession rights from the state to the private sector, but extended to the numerous, and highly controversial, renegotiations of the initial contracts within which rate hikes figured prominently. Guasch and Straub (2006:483) estimated that between 1985 and 2000 contract renegotiations in Latin America involved 74 percent of water concession and 55 percent of transport concessions. More to the point, such renegotiations took place shortly after private companies won the award. Although most contracts had a 15-year life span, in the water sector renegotiations occurred, on average, after 1.6 years, whereas in transport it took 3.1 years.

Bonnet et al. (2006) recently developed a more encompassing model than Panizza and Yañez's (2006) to assess the determinants of public opinion vis-à-vis privatization. Besides economic and social independent variables, their model includes corruption, institutional variables and several demographic, employment, asset, and access to service variables. Bonnet, et al. (2006) set up a "pseudo panel" model in order to take into account unobserved individual effects, which Panizza and Yañez's (2006) did not consider. According to Bonnet et al. (2006) once you introduce controls for fixed unobserved characteristics linked to the ideological orientation of individuals, present and future economic situations are no longer significant. Conversely, Bonnet et al. (2006) results confirm previous findings by Checchi et al. (2005) who concluded that those who were likely to have suffered from privatization, such as public sector employees and the unemployed, were the most critical about privatization. Similarly, those who identified themselves as right-wing, and may have had high expectations, were more likely to be disappointed--and therefore dissatisfied--than left-wing sympathizers. Moreover, Bonnet el al. (2006), find that corruption does matter, as can be seen in columns three to five. Likewise, complementary opinion variables such as trust and democracy preference are mostly significant and with the expected negative sign. This further suggests the importance of corruption as a powerful explanatory variable. In fact, Bonnet et al. (2006:27) contend that, "the preference for democracy is likely to capture a related aspect to the extent that individuals expressing a stronger preference in that sense may also be expecting a more participatory and transparent policy making process." In other words, people who believe in the democratic process tend to form pessimistic evaluations of privatization due to its lack of transparency and the probability that such policy was manipulated for corrupt ends.

Conclusion: Are we on the brink of a new era of nationalizations?

In the past few years, the nationalizations and contract renegotiations that Chavez, Morales, and Kirchner imposed on private infrastructure utility operators have dominated the headlines coming out of Latin America. Does this

Table 1. Macroeconomic Factors and Supports for Reform

	(1) Priv.	(2) Priv.	(3) Priv.	(4) Priv.	(5) Priv.	(6) Market	(7) Market	(8) Market	(9) Market	(10) Market
GDP Gap	0.012				0.014	0.032				0.04
	(5.36)***				(2.72)***	(5.22)***				(3.08)***
Unempl.		-0.023			0		-0.05			0.022
		(3.01)***			-0.01		(2.16)**			-0.62
Inflation			0.416		0.585			1.826		2.146
			-1.35		(4.18)***			-1.35		(3.01)***
Depth of Crisis				-0.016					-0.048	
				(4.63)***					(4.66)***	
AGE	-0.001	-0.001	-0.001	-0.001	-0.001	-0.001	0	-0.001	-0.001	0
	(2.87)***	(2.33)**	(3.00)***	(2.91)***	(2.35)**	-1.58	-1.22	(1.94)*	-1.62	-1.17
SEX	-0.015	-0.017	-0.016	-0.015	-0.017	-0.017	-0.022	-0.021	-0.018	-0.018
	(2.78)***	(2.89)***	(2.78)***	(2.78)***	(2.86)***	(3.28)***	(3.96)***	(3.71)***	(3.53)***	(3.07)***
quintile==2	-0.008	-0.002	-0.008	-0.008	-0.002	0.001	0.005	0.004	0.002	0.006
	-1.06	-0.3	-0.99	-1.03	-0.24	-0.12	-0.53	-0.44	-0.21	-0.65
quintile==3	0.003	0.01	0.002	0.002	0.011	0.016	0.018	0.014	0.015	0.021
	-0.27	-1.12	-0.16	-0.25	-1.29	-1.61	(1.85)*	-1.47	-1.58	(2.14)**
quintile==4	0.02	0.029	0.02	0.02	0.029	0.023	0.032	0.03	0.024	0.03
	(1.80)*	(2.94)***	(1.79)*	(1.82)*	(2.97)***	(2.26)**	(3.38)***	(2.86)***	(2.25)**	(3.47)***
quintile==5	0.079	0.089	0.078	0.079	0.09	0.039	0.052	0.043	0.039	0.05
	(4.84)***	(5.56)***	(4.78)***	(4.84)***	(5.66)***	(2.69)***	(3.56)***	(3.00)***	(2.67)***	(3.83)***
Constant	0.398	0.622	0.364	0.425	0.334	0.558	1.041	0.391	0.646	0.122
	(23.09)***	(8.25)***	(10.14)***	(21.66)***	(2.37)**	(34.75)***	(4.68)***	(3.02)***	(33.13)***	-0.34
Observations	65,083	58,013	65,083	65,083	58,013	48,009	42,615	48,009	48,009	42,615
R-squared	0.04	0.04	0.03	0.04	0.05	0.1	0.05	0.05	0.09	0.15

Source: *Panizza and Yanez (2006)*

mean that this trend will affect other countries in the region any time soon? The evidence suggests that this will unlikely be the case. Between 1990 and 2001 less than 2 percent of the 2,500 private infrastructure projects suffered nationalizations or cancellations (Harris 2003:10). This number has increased only slightly since then, and in South America remains primarily circumscribed to Argentina, Bolivia, and Venezuela. As noted earlier, nationalizations and contract renegotiations have occurred mostly under populist presidents. More ideologically oriented leaders in Brazil, Chile, Peru, and Uruguay have instead realized that growth can only come if market conditions are favorable to foreign and domestic private investments. In other words, for these politicians the engine of economic growth remains the private sector. Thus, they have limited themselves to the redistribution of wealth toward the lower social classes, but have not tampered with private property. Kirchner himself seemed to have adopted a mixed political strategy. In the cases of some water companies and the national postal service, he proceeded in re-nationalizing utility companies managed by foreign and domestic investors. However, in most other cases, he has aimed at replacing foreign investors in key infrastructure utilities with domestic ones whom he can manipulate more easily.

However, it is unmistakable that fewer and fewer people in Latin America believe that market economics alone is the best way to develop their countries. According to the Latinobarometro, in 2007 people expressing confidence in the market were only 41 percent as opposed to 57 percent in 2000 (The Economist 2007). This is a significant drop, but again it must be interpreted with caution. The very fact that the bulk of Latin Americans identify themselves to be on the center-right of the political spectrum would suggest that the loss of confidence in market reforms is not due to an ideological change of heart but rather to disillusionment with their results. In brief, people may not want less market but a better, more competitive and efficient one that creates opportunities rather than corruption, collusions, and rents under private ownership. Analysts agree that when the divestiture process is transparent, and brings competition (when possible), effective regulation, universal service expansion (particularly for the poor), and fair tariff rates, consensus and trust in support for privatization solidify. As Estache (2005:293), pointed out, “The less transparent the reform process—the less accountable decision makers and other actors intervening in and interfering with the decision process are—the more likely reforms and marginal players, rather the actors guilty of failures, will be blamed.” The challenge for pro-market politicians remains to find the appropriate strategy to build consensus around privatization, through a transparent process that takes into account local realities, while making sure that such a policy bears the expected fruits.

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A Remarkable Transition: Banking in Central and Eastern Europe#

Introduction

Banking in the transition countries is particularly interesting because banks played no economic role in planned Soviet-style economies. One of the first steps taken with the political transition was the establishment of a banking system which largely consisted of state owned institutions. Over the course of the last 15 years these brand new banking systems have been remarkably and quickly transformed into private institutions that compete with up to date technology and provide financial services efficiently and serve admirably to intermediate saving and investment. Banking sectors in many transition economies look little different from their counterparts in other emerging market economies; banking in transition is a notable success story that warrants telling.

Banking sectors emerged from the planned economy in a difficult process that took place amidst massive macroeconomic collapse and considerable economic uncertainty. Not surprisingly, these new banking sectors experienced crises ranging from serious bad loan problems to total collapse. In just a few years, countries responded to the bad loan problem and began the process of bank privatization, and introduced the necessary regulatory framework. Mature banking sectors with a dominant role of foreign banks emerged remarkably quickly. The ongoing global financial crisis presents significant challenges to this success story which still has a way to go.

Banking in the Early Stages of Transition

Banking sectors in the European transition economies were relatively underdeveloped compared with the real economies in these countries due mainly to the legacies of the pre-transition centrally planned economy. As examples of real sector development, Czechoslovakia had a relatively modern automobile industry, Hungary produced buses, and Bulgaria made computers and software for use within the Soviet bloc. However, in the planning framework, financial intermediation between savers and borrowers was internalized wholly within the state banking apparatus. Capital was allocated through a system of directed credits to state-owned enterprises for both investment needs and budget allocations for the working capital necessary to meet the output plan. Credit evaluation and risk management played no role in lending decisions.

In the planned economy, the national monobank served only as an accounting clearing house for transactions and the planning decisions. In addition to the national monobank, pre-transition banking sectors typically included a foreign trade bank that isolated foreign currency transactions from the domestic financial system and a state savings bank which collected deposits and did little lending. There were of course differences among the transition countries. Banks in Hungary and Yugoslavia for example resembled Western banking

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institutions more closely than those in the Soviet Union.

The first step in banking sector reform for most transition economies involved the creation of a two-tier system which separated the national monobank into a traditional central bank with responsibility for monetary policy, bank supervision and exchange rate policy, and one or more state owned commercial banks (SOCBs). In addition, in some countries lax entry requirements led to the creation of many new private banks which were more often than not severely undercapitalized.

Several factors at work in the early transition period sowed the seeds for banking crises which occurred in every country. First, the dominant state owned commercial banks were expected to continue supporting state owned industry and had little ability to develop appropriate commercial lending standards. Second, the adoption of lax entry requirements with the intent of fostering competition for state-owned banks led to the emergence of many banks with dubious or even fraudulent activity. Third, the nascent regulatory systems were overwhelmed by the mismatch between their capabilities, which were severely restricted by a lack of human capital, and their mandates provided by quickly adopted standard financial rules and regulations.

Each country approached the creation of SOCBs differently. In Hungary, the commercial portfolio was divided by sector, establishing banks for industry and agriculture. In Poland, the commercial portfolio was divided along regional lines based on the regional offices of the national monobank. In the Czech Republic, Slovakia and Romania one monopoly commercial bank emerged with the entire commercial portfolio of the national monobank. In Russia, then the Soviet Union, the two-tier banking system was established in 1987 with the separation of all commercial bank functions from the national monobank. Each branch became a commercial bank and many banks were established by enterprises or government ministries. By 1995, three were 2,300 banks in Russia, many of which were small and poorly capitalized and some were merely internal banks owned by enterprises.

Policies toward foreign bank participation differed considerably across the transition countries. In a few countries, policy encouraged the entry of Greenfield foreign operations. In most others, licensing was restrictive and foreign banks were limited to taking minority stakes in SOCBs or to participating in the resuscitation of ailing smaller domestic banks. Even before the political change, the Hungarian government pursued a liberal licensing policy toward foreign financial institutions. By 1995, foreign financial institutions held almost 42% of banking assets in Hungary due in large part to the privatization of two SOCBs to foreign owners. In contrast, the Czech Republic and Poland restricted new licenses for foreign banks and invited foreign owners to take only minority equity positions in existing banks. These governments followed a more protectionist strategy, taking an infant industry approach according to which domestic banks are nurtured to become strong enough to fend off foreign competition. Although foreign participation in the banking sector was widely viewed as a means of importing banking expertise and technology, most countries restricted entry. By 1995, only about 16% and 4% of the banking assets in the Czech Republic and Poland, respectively, were owned by foreign financial institutions.

For the most part, governments in transition countries succeeded in establishing the foundations for building commercial banking sectors early in the transition period. However, developing modern banking sectors required the completion of three interrelated tasks--namely, the resolution of non-performing loans, the privatization of the SOCBs, and the establishment of effective regulatory institutions.

The Development of Modern Banking Sectors

The typical banking sector in a transition economy consisted initially of state-owned banks that were carved out of the planned economy structure along with newly established small private domestic banks. Most countries developed market-based legislation for banking and created supervisory institutions, but these steps did not lead automatically to good banking practices. First, the SOCBs continued to maintain banking relationships with their traditional clients, the state owned enterprises. Such lending was either politically mandated or simply the result of long-standing relationships between clients having little experience in choosing viable projects and banks unable to evaluate the risk of loans. Second, in many countries, de novo banks were created without adequate regulatory oversight. A lenient entry policy was thought to be a way of introducing competition into the banking sector but it also led to a proliferation of poorly managed and undercapitalized new banks. The regulators were over burdened and mismanagement, diversion of funds, and fraud were not uncommon. Although most countries adopted modern banking and regulatory legislation immediately, inexperienced regulators were unable to provide effective supervision immediately.

Not surprisingly, bad loans were a serious problem for all transition economies due to the legacy of relationships with government owned enterprises and also to continuing lending practices. Most governments responded to failing banks with efforts to save them from closure by recapitalization and the removal of bad loans from their balance sheets. Repeated problems were inevitable because recapitalizations addressed only the stock of existing bad loans. SOCBs continued to lend to government enterprises and the flow of new bad loans continued to accumulate. Regulators did not have proper incentives, the requisite expertise, or sufficient independence to cope with this problem. To some extent the bad loan problem was unavoidable because transition recessions and the dissolution of trading relationships within the Soviet bloc generated severe real sector shocks that were mirrored on the balance sheets of the banks.

Although these problems were difficult to resolve, progress started in a few years and the ratio of non-performing loans to total loans was well under 10% in most countries by the mid 2000s. For example, Hungary began to address bad loan problems in the early 1990s and started selling banks to foreign investors in 1995. By the end of the decade, the Hungarian banking sector was well capitalized, loan quality had improved, claims on the state were a declining share of bank assets, bank staffing declined, bank margins narrowed and, incidentally, bank regulation improved markedly. The process took somewhat longer in the Czech Republic, where voucher privatization funds led to connections between banks and enterprises, more bad loan problems and the banks reverting to state ownership. It took until the end of 1990s before foreign investors were allowed to take majority stakes in the large Czech banks and bank behavior changed accordingly.

The privatization process differed considerably across the European transition countries. In Poland, efforts to privatize banks quickly on the domestic stock market backfired because the market was not very well developed. Later efforts to manage mergers and acquisitions were controversial and almost a quarter of Polish bank assets remained in state hands as late as 2005. In other countries bank privatization programs involved negotiated deals between the government and a single foreign bank, sometimes after a tender. After a decade and a half of transition, privatization of SOCBs is largely completed in central and Eastern Europe, although the situation is different in many countries of the former Soviet Union.

The surprising aspect of banking in the transition countries is not the depth of the crises after the end of communism but the speed with which financial restructuring took place subsequently. The rapid changes in the decade starting in the mid 1990s can be attributed to two related phenomenon. First, the desire of European transition countries to qualify for EU membership was a strong force for reform, not only in the eight original transition accession countries but also in the later joiners and in countries still hoping to join. Second, the prospect of EU membership (and ultimately the adoption of the Euro) made these under-serviced banking markets attractive to European banks once macroeconomic stability was attained and reasonable regulations were in place.

The proportion of assets in foreign-owned banks rose from virtually zero in the early 1990s to more than half in most countries a decade later. By 2005, the share of assets in foreign-owned banks was over 90% in the Czech Republic, Slovakia and Croatia. The countries of the former Soviet Union are an exception; foreign banks are not a major factor in Russia or in any other former Soviet republic, except for the Baltic countries. Russian banking regulations continue to restrict foreign participation by setting a limit on the overall size of the foreign banking sector and establishing minimums for the number of Russian employees and board members in foreign banks. In addition, unstable supervisory environments and weak legal protection have deterred foreign interest in such investments.

The relationship between parent banks and their local partners is a mixed blessing. In some cases, the parent bank provides assistance for a troubled local institution, as when KBC from Belgium supported its troubled Polish subsidiary. However, parent bank support cannot be taken for granted, sinceBayerische Landesbank walked away from its Croatian subsidiary, Rijecka Banka, when fraud was uncovered. These relationships are likely to be particularly important as the global financial crisis spreads. Will weakened parent banks continue to lend and increase the capital in their transition country subsidiaries?

The EBRD index of banking reform provides an overall measure of progress. In 1999, only Hungary had a rating of 4.0 on a scale from 1.0 to 4+, where the highest score reflects full convergence to performance norms and regulation standards of advanced industrial economies. By 2005, the Czech Republic and Croatia joined Hungary with scores of 4.0 while most other countries recorded increases. Hence, banking sectors in most transition countries have reached, or are rapidly approaching, their counterparts in developed market economies with one major difference, namely, an extremely high foreign bank presence. Banking concentration is high in most transition countries but this is typical of small open economies throughout the world. While interest rate spreads have declined, they remain high in many European transition countries. Neither high foreign participation nor low inflation is a sufficient condition for competitive interest rate spreads.

Transition Banking and the Global Crisis

According to the 2006 EBRD Transition Report, the banking sectors of transition economies have exhibited considerable growth and diversification since 2000, although further progress in financial deepening is considered to be

both feasible and desirable. Even in the most advanced transition countries, the ratio of loans to GDP is around 50%, much less that then the average for Western EU countries. Even the leading transition countries are well below the EU average in providing credit to the private sector.
Generally, financial deepening or increasing intermediation is associated with more rapid economic growth. Thus, the increased credit ratios in many transition countries should be viewed as a positive development. However, rapid credit deepening can be a cause for concern particularly when it comes in the form of rapid growth in mortgage lending, often denominated in foreign currency, and other forms of consumer credit. For example, a credit boom in Croatia led to an increase in the loans to GDP ratio from 36% to 56% from 1999 to 2005 and lending to households was more than one-half of the total in 2005. Although rapid credit growth might have long term economic benefits, it could also be a sign of short term excessive risk taking and financial vulnerability.

In addition, much of the lending by banks in transition countries is denominated in foreign currencies. Even though the deposit base of these banks is also in Euros, foreign exchange risk is not eliminated by this matching because a domestic slowdown or exchange rate shock would affect the ability of domestic borrowers to repay in Euros. The use of foreign currencies on bank balance sheets, much like fixed exchange rate regimes, increases the vulnerability of domestic economies to the global crisis.

Credit growth throughout the region slowed in 2007 and 2008 as the international financial crisis affected economies, particularly those that were closely integrated with the Euro area (Hungary and the Baltics) or vulnerable to swings in energy prices (Russia and Kazakhstan). Countries with macroeconomic imbalances were particularly vulnerable to the world wide credit crunch that reduced volume in international bond and syndicated loan markets. However, the banks in the transition countries were relatively unaffected in the initial stages of the crisis. They did not experience large write offs and short term funding from parent banks seemed to hold up through 2008.

Many large enterprises, particularly in the EU new member states, are able to take advantage of recent increases in European capital market integration and obtain financing from abroad often in the form of loan syndications with the participation of domestic banks. However, these sources of funding fell with the global credit crunch starting in 2007 and the domestic banks may not be able to cushion the affects of the global credit crunch.

Foreign bank ownership may make transition banking systems vulnerable to the world wide credit crunch. Although there are no reports of transition country banks suffering large losses on U.S. mortgage securities, their European parent banks may have. In this case, the parent banks may be less willing to provide funding to their transition subsidiaries and credit standards may tighten as the parent banks reduce risk exposures across the board. Further it is unclear that every transition country central bank will be able to maintain liquidity in the banking sector and confidence in domestic institutions if the foreign parent banks withdraw support.

Banking regulation in the European Union follows the home country principle in that the home country regulators supervise the consolidated balance sheets of multinational banks. At the same time, the host country regulators have responsibility over the local subsidiaries. Hence, a potential for conflict arises if a home country regulator does not have sufficient interest in a foreign subsidiary that is a small part of a multinational bank but an important player in the financial sector of the host country. The lack of explicit coordination of bank regulation across borders is a problem that is overdue for attention. For example, the British authorities were not prepared to deal with the failure of the Icelandic banks that had large UK subsidiaries. It is entirely unclear how authorities in both home and host countries would respond to the failure of any parent bank with subsidiary operations in the transition countries.

The resiliency of transition banking does not mean that the sector will be immune to the upheaval in world financial markets. Hungary was among the first emerging market countries to suffer the fallout of the global credit crunch. It was vulnerable because of a large fiscal deficit, its reliance on external financing and the extent of domestic borrowing in foreign currency. The credit crunch led to pressure on the florint and an increase in the country risk premium. In October 2008, the IMF, the World Bank and the EU joined forces to provide a $25 billion support program. Importantly, the program included provisions for preemptive additions to bank capital and guarantees for the interbank market. That is, the macroeconomic issues and financial sector stability are inseparable problems. Several other transition countries are likely to reopen borrowing programs with the IMF. Their problems tend to be related to real sector imbalances and contagion from the global recession rather than their own banking sector problems.

Prospects for the Future

Although banks in the transition countries have made rapid strides in improving performance and services since the early 1990s, the banking sectors in the European transition economies still do not posses the financial depth of their EU counterparts nor are banking services as well developed in these countries. Nonetheless, with few exceptions (primarily in the former Soviet Union), the transition in banking is complete. State monobanking structures have been replaced by privately owned, market-oriented, well-capitalized banking institutions that are independent from the government and from state-owned clients. The legal environment has improved with respect to bankruptcy laws, collateral laws, and confidence in the application of the law. Furthermore, banking regulatory and supervisory capabilities have developed considerably. Thus, any evaluation of the structure of banking in transition countries must be positive. However, banking conduct is a somewhat different matter; any evaluation of what banks are doing and how they are contributing to economic performance in the transition economies must be more nuanced.

Much of the recent growth in banking comes from household lending which may be a consequence of the dominance of foreign-owned banks. Once the legal environment is in place, lending to households is a commodity business that can be entered easily through the application of banking technology from abroad. In contrast, lending to enterprises requires developing client relationships and having the ability to evaluate unique situations, both of which require expertise that is generally lacking in foreign banks. Indeed, despite rapid credit expansion, enterprise surveys indicate that many firms are financially constrained in the sense that they are unable to obtain bank lending. Based on these surveys, the EBRD concludes that “despite some regional variation, bank loans still play a limited role in enterprise financing” (EBRD Transition Report, 2006, p. 47). Since lending to enterprises is important to support economic growth, this finding has important implications for any evaluation of the conduct of banking in transition countries.

The risks and indeed many of the problems, faced by banks in transition countries are familiar to banks in small, open, emerging-market economies around the world. Although consolidation eliminates inefficient and undersized institutions, it also increases concentration, which may limit competition and create systemic risks. To some extent, free entry and foreign bank participation can mitigate this anti-competitive tendency. However, the dominant presence of banks from a few host countries (Netherlands, Italy, and Austria) with strong trading relationships or to a desire to enter expanding new markets close to their own countries can increase risks. Although foreign-owned banks have maintained their lending activities in the presence of local shocks, their aggressive growth targets may be a source of instability in the future.

In summary, remarkable strides have been made in developing mature banking sectors in virtually all European transition countries. However, this positive evaluation must be tempered by some concerns about the future. First, the global crisis and the dominance of foreign banks from a handful of countries raises concern for the stability of many banking sectors. Second, although the growth in banking in transition countries has made available many financial services which were simply not obtainable before, whether banks have become formidable engines of sustainable economic growth in transition economies remains an open question.

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Privatise or not? The dilemma for pension reform

Privatisation and pensions

Since the 1980s the debate concerning the superiority of public versus private provision has swung strongly in the direction of private provision, Led by the UK, there has been a vast wave of privatisation of assets around the world. Over the last quarter-century, well over $3 trillion worth of assets have been privatised worldwide. In many countries, privatised companies are the biggest listings (measured by capitalisation), and it is not unusual for emerging markets to have all or nearly all of their equity listings originating from privatisation proceedings. Privatisation has been generally perceived as a method of improving efficiency, reducing state intervention, increasing political support for the government and playing a vital element of the market creation process (e.g., in transition economies). Whether individual privatisations have delivered what they were expected is another question (e.g., the results of the privatisation of the railway network in the UK, or of the privatisation of the Russian economy remain rather controversial), but in general, support for privatisation over time and across countries has been sufficient for local governments to put state-owned companies under the hammer without facing widespread protests, strikes and tough talks with trade unions.

The story looks very different when it comes to the reform of old-age provision. Replacing entirely (or simply reducing) the state-guaranteed Pay-As-You-Go (PAYGO) schemes with privately held and managed pension schemes is probably one of the most debated and controversial reforms of our times. Although the need for the reform is widely accepted, its form is not. Even within the European Union differences among individual members are substantial and no real effort is made to 'unify' pension systems across boarders. However, finding a solution to the pension crises is critical both for developed and developing countries.

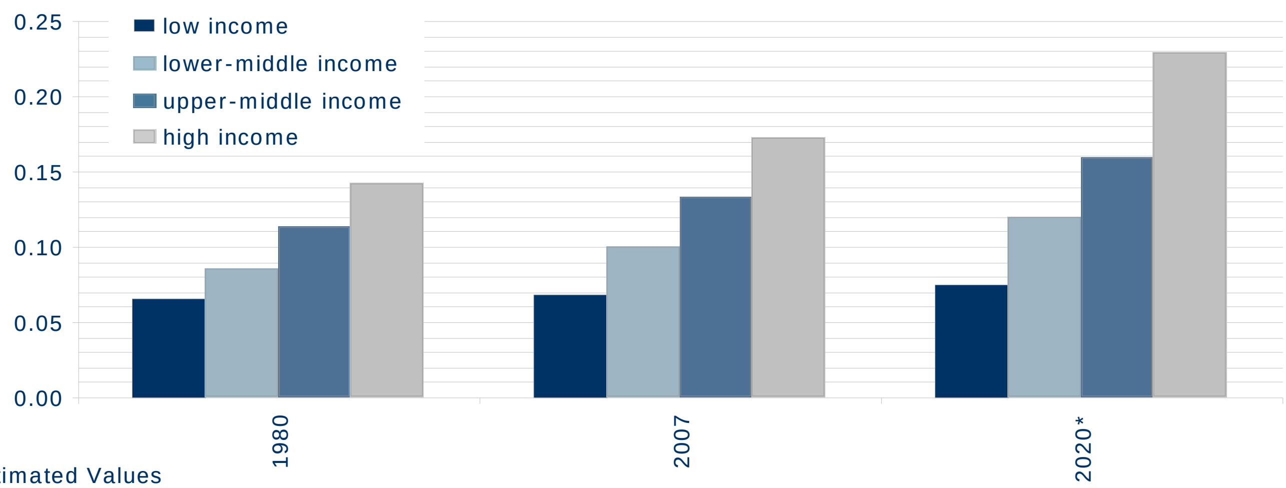
Reforms have centred around either restructuring the existing state PAYGO systems or creating compulsory and voluntarily schemes that provide additional saving opportunities. These schemes are often, and in many countries exclusively, run by non-governmental financial institutions. Hence, they reduce state ownership over the pension sector and the large scale introduction of compulsory and voluntarily saving retirement schemes is frequently viewed as privatisation of the pension industry.

The global aging problem

While it is common knowledge that the population of developed countries is aging quickly (see Figure 1), the fact that developing countries are not that far behind is less well appreciated. Although the current average old-age dependency ratio for developed countries is over twice that of developing countries (22.6% against 10%), there are many developing countries where the dependency ratios are comparable with those of the developed countries. For instance, if countries are ranked according to old-age dependency ratios (highest first) and we take the top 20 countries, then seven of these twenty are developing nations. If instead we consider the top 30, then 14 are developing countries. Indeed, the old age-dependency ratios of Croatia, Fiji, Bulgaria, Equatorial Guinea, Latvia and Ethiopia are currently higher than the old-age dependency ratio of Spain (that is nearly 25%). Moreover, the proportion of old to working age population is increasing rapidly in developing countries. For example, in the period 1980-2007 the old-age dependency ratio increased on average by 25% in developed countries compared to 14% for the developing ones, however a more detailed comparison of the statistics shows that the average for developing countries is so much lower only because the average ratio for low income countries was very low. If we divide countries according to their GDP per capita, high income countries and middle income countries have experienced very similar increases in the old-age dependency ratio (21% and 18% respectively) in the period 1980-2007. In contrast, the ratio for low income countries changed on average by only 2%. However, even low income countries are projected to start aging faster in the coming years. For example, their old-age dependency ratio is expected to change by 10% in the period 2007-2020.

Figure 2 presents the time trend of the two main components that contribute to the increase in the old-age dependency ratio--the fertility rate and the life expectancy at birth in the period 1962 -2006. The decline in the fertility rate for all income categories is remarkable. Indeed the fertility ratios for the high and middle income countries have became very similar (Figure 2, Panel A). However, the speed of decline is more dramatic for poorer countries because the rates in the 1960s were very different, particularly between high and lower middle income countries. The developed countries' average fertility rate declined by 42% (from 2.96 to 1.72) over the 1962-2006 period, while the lower-middle and the upper-middle income countries experienced declines of 69% and 51% respectively. In the low income countries fertility rates have dropped by 47%. It is true that in recent years in the middle income countries women still give birth more often (2.10 and 2.01 total births per woman in lower-middle and upper-middle countries respectively), but, since the mortality of infants in poorer countries is also higher, these marginally higher figures will not protect poorer countries from the spectre of rapid demographic aging in the coming decades.

Figure 1. Average old-age dependency ratio per income group.



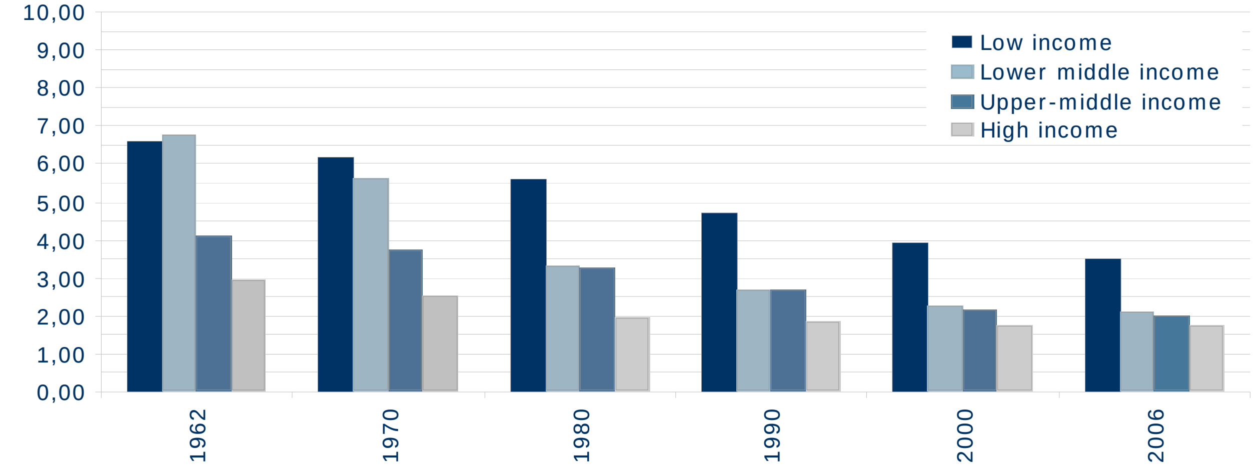
*Estimated Values
Source: World Development Indicators

Finally, when considering life expectancy at birth, we see that the gap between high income and other countries has also narrowed (Figure 2, Panel B). For example, life expectancy within high income countries has increased by nearly 15% whilst the increase in upper-middle, lower-middle, and low income countries has been respectively 18%, 33% and 37%.

What benefits does the private approach bring?

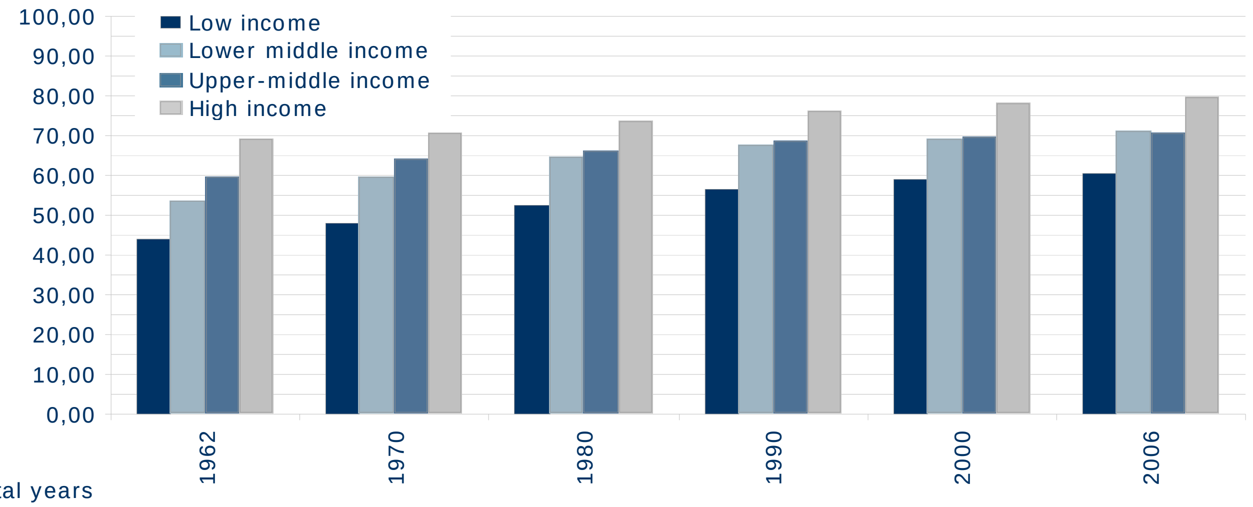
The evidence in the previous subsection clearly shows that both developed and developing countries are in desperate need of pension reform and that it is an urgent global concern. However, despite the fact that the developed countries' old-age dependency ratios are rising and are expected to continue to do so, it can even be argued that the need for reform is stronger in developing countries. This is because the lack of decent old-age provision in developing countries tends to push many individuals below the poverty level once they retire. Therefore, securing old-age provision should not just be seen as a fiscal programme, but also as a central part of the social and economic agenda to fight against poverty. Given that nearly 86% of the world's population lives in developing countries, the argument for pension reform in the these countries, which equate broadly with the emerging stock markets, is particularly strong.

Figure 2. Panel A - Average fertility rate* per income group



*total births per woman
Source: World Development Indicators

Figure 2. Panel B - Average life expectancy at birth* per income group.



*total years
Source: World Development Indicators

This begs the obvious question, what can be done to make things better? To date, two major streams of reforms have been undertaken, (i) reform of the existing PAYGO systems, and (ii) creation of compulsory and voluntarily schemes (the so called, second and third pillars) that give people additional saving opportunities and hence are expected to become the main sources of old-age provision for individuals. As indicated in the introduction, while PAYGO schemes remain in state hands, compulsory and voluntarily schemes are often, and in many countries exclusively, run by non-governmental financial institutions.

Is the creation of compulsory and voluntarily schemes beneficial? The schemes have a 'personal account' structure which provides individuals with an opportunity to save for their own retirement rather than put money in a common pool in the hope that the future generation will do the same. It is also anticipated that they will have a 'macro' impact on local economies. First, they impose tighter budget constraints on local governments as they restrict governments from shifting money from the pension pool to another sector to fill gaps in a budget. They also release some funding that would be needed to support an inadequately funded PAYGO scheme to support other projects. Third, the creation of financial institutions that have at their disposal money ready to be invested could stimulate both the development of a local financial market and the economy as the whole.

Indeed, when in the early 1980s, the World Bank started to champion the idea of pension reform via the introduction of a three-pillar system, it was argued that the creation of big institutional investors would lead to financial market deepening. In particular, it was argued that pension funds would enforce prudence and transparency of market structures and operations leading to physical and operational development of local financial markets. As a market's efficiency improved, more firms would become listed, which would result in more capital coming on the market. This would improve market liquidity, which in turn, would improve market efficiency. In addition, corporate governance of listed (and indirectly non-listed) companies would grow stronger, which would stimulate economic development.

In addition to these benefits, pensioners would expect better pensions than if they deposited their savings in government-run PAYGO. This is because the money would be invested in a broad range of assets giving contributors a chance to benefit from diversification of pension funds' portfolios.

Table 1. Two biggest sectors as a percentage of the total market capitalisation for selected emerging markets that initiated a pension reform under supervision of the World Bank (2006)

Country	Mining and quarrying	Electricity, gas and water	Transport, Storage and Communications	Financial Services	Total for the two dominant sectors
Bolivia	48.60			21.87	70.47
Kazakhstan	66.15			27.69	93.84
Kyrgyz Republic			37.66	44.46	82.12
Latvia			56.10	30.28	86.38
Morocco			21.90	52.50	74.40
Nepal		8.84		85.64	94.48
Peru	55.75			16.17	71.92
Romania		40.29		40.62	80.91
Slovakia	68.50			27.19	95.69

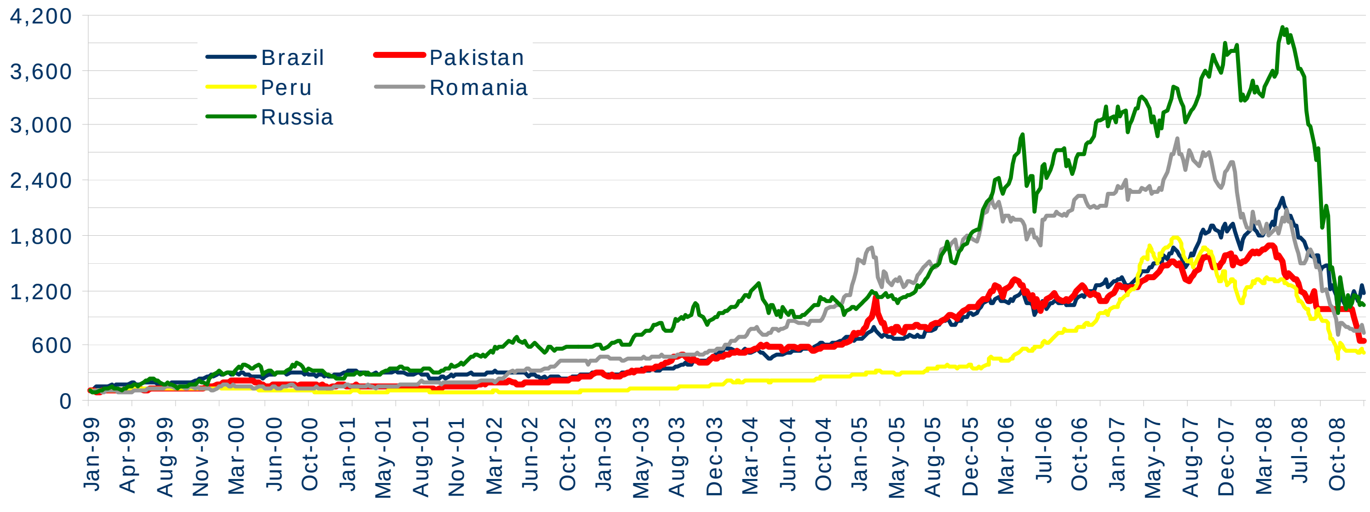
Source: World Bank

So, from the perspective of government spending, the introduction of compulsory and voluntarily schemes brings considerable benefit particularly as these schemes have reduced the direct burden of subsidising the PAYGO. Furthermore, since workers are made directly responsible for how much money they save and pension funds are responsible for generating returns and facing retirement liabilities, governments may feel more relaxed about their obligations towards retirees. Unfortunately, it does not seem so obvious that pensioners themselves, and economies in general, have benefited from the privatisation of the pension industry. A central issue has been the impact on financial markets. Putting aside the debate whether nationalisation of the Argentinean pension funds in 2008 is an example of a rescuing or a grabbing hand, the experience of other countries places a big question mark over the idea of the pension industry privatisation in the current development of capital markets. The next subsection considers the impact on financial markets in more detail.

The impact on financial markets

The drive behind the creation of additional saving schemes was to reduce the state's responsibility towards retirees and to secure better retirement outcomes for pensioners than PAYGO could offer. However, for the latter to happen the deposited savings need to earn a decent rate of return. However, in many countries, and this applies to both the developed and developing ones, pension funds have faced significant restrictions on their investments. As a result, the majority of pension funds' assets are invested in bonds and listed stocks, and in many countries these two assets are practically the only assets that constitute pension funds portfolios. Even more, there are cases, unfortunately not so rare, that pension funds' are allowed to invest only in government bonds. This obviously undermines the idea of separation of the pension industry from the government and clashes with the argument of portfolio diversification. But even if pension funds are allowed to invest in listed stocks, and actually do so, it hardly makes things better. In the case of the emerging markets, local stock markets are illiquid and small, and offer just a handful of stocks that are concentrated around one or two sectors. For instance in Cyprus and Iceland, one of the richest countries in the emerging markets group (at least until recently), the financial sector represented 85.8% and 86.6%, respectively, of the total market capitalisation in 2006. On average, the financial sector is the biggest in the sense of capitalisation and makes up to nearly 38% of the emerging stock

Figure 3. Stock market indexes for selected emerging markets (Jan 99 - Jan 09)



Source: Datastream

market capitalisation (compared to about 28% of markets capitalisation of the developed exchanges). In the current meltdown of the banking industry, this does not give great hope for superior performance from emerging markets. To illustrate this sector concentration issue, Table 1 shows the contribution of the two biggest sectors to the total capitalisation of the relevant domestic stock markets for selected emerging markets that have undertaken pension reform. It is clear from the table that the sector concentration in the emerging markets is a real issue.

However, the lack of diversification of the portfolios of pension funds' is not the only concern. The size of local stock markets is also an issue. Since the capitalisation of emerging markets is typically a small fraction of GDP, pension funds may acquire such a significant proportion of a stock market that their portfolios will account for almost all the free float of the firms. In addition, high volatility of emerging markets exposes contributors to significant risk. To provide an example from recent events in 2008 the MSCI index dropped 43.9%, but the Emerging Markets MSCI index shrunk by 54.9% with such important markets as the Russian and the Chinese declining by 72.4% and 65.4% respectively. Figure 3 shows the movement of selected stock market indexes for emerging markets over the last 10 years. All indexes are quoted in local currencies so that it is consistent with the currency that their liabilities are denominated in. The picture illustrates that over the period of the last ten years the emerging markets shown did well as the indexes increased between 5-10 times. However, the volatility is such that anyone who has invested the last three years would now be significantly worse off.

To summarise, the process of reforming the pension industry in emerging markets has started on a massive scale, with billions of Euros being collected and invested outside PAYGO schemes. Hundreds of millions of people have started to invest in compulsory and voluntarily pension schemes. Table 2 shows the number of people investing directly in shares and the indirect share-ownership enhanced by pension funds in selected emerging that have compulsory saving schemes. These numbers will grow over time, in some countries slowly, in some rapidly. For instance, the coverage of compulsory saving schemes in China is still low (about 4% of the population), but as the reform progresses and more individuals join the schemes, China alone may produce more shareholders than all developed countries together.

However, simply privatising the industry is not enough. There is still a long way to go, or the sacrifices made may not result in adequate returns for retirement. Investing on local stock markets (either by choice or enforced) tends to expose investors to high risk that is not necessarily compensated with sufficient return. In addition, these comparatively large pension funds tend to capture a very high

Table 2. Direct and Indirect (via pension funds) share-ownership in selected developing countries

Country	Number of direct shareholders	Year	Number of Indirect Shareholders	Year	Ratio of Direct to Indirect
Chile	636,474	1999	8,043,808	2007	12.60
China	76,700,000	2005	116,000,000	2005	1.50
Russia	204,000	2006	6,503,980	2007	31.90
Poland	909,000	2006	13,134,081	2007	14.40

Note: Chile was the first developing country to initiate pension reforms in 1980. The other three countries have initiated pension reform in the last ten years.
Source: World Bank

proportion of the free float of local stock markets resulting in dampened rather than enhanced market development. Therefore, if the privatisation of the pension industry is to be successful, pension funds should be granted more discretion in their choice of markets and assets.

Selected News

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CZECH REPUBLIC

2009-01-09 - **Czech Government Launches CSA Czech Airlines Privatization**
PRAGUE (Dow Jones)--The Czech government has launched the privatization of Czech flagship carrier **Ceske Aerolinie AS** (CSA), Prime Minister Mirek Topolanek said Monday. The sale tender of the state-owned 91.51% stake in the airline will be carried out in two rounds. The successful bidder's main business must be air transport, it will be obliged to maintain the national carrier status of CSA Czech Airlines and it will have to pass security clearance by Czech authorities. The successful bidder will also keep the airline's base at the Prague International Airport. In December, the Finance Ministry, which oversees the sale, already appointed a consortium of Deloitte Advisory and CMS Cameron McKenna as its adviser in the privatization. The state aims to privatize CSA Czech Airlines, the smallest member of Air France KLM-led SkyTeam alliance, by mid-2009. Analysts expect the state to generate about $270 million from the sale. So far, Russia's OAO Aeroflot and Icelandic airline Icelandair Group Holding have expressed interest in the Czech carrier tender. Aeroflot is also a SkyTeam member, while Icelandair is active on the Czech market through its controlling stake in privately-held Travel Service, the country's largest charter airline.

2008-09-15 - **Czech Finance Ministry: Prague Airport Sale Safe Deal Amid Market Crisis**
CESKE BUDEJOVICE, Czech Republic (Dow Jones)--The fall of banks and ensuing financial crisis on global markets is helping, rather than hindering, the Czech government's planned sale of **Prague International Airport**, the finance minister said Monday. "(I don't see) any negative impact on the privatization of the airport from the financial sector crisis, rather the opposite," Miroslav Kalousek told Dow Jones Newswires on the sidelines of a press conference during a tour of the southern Czech Republic. Kalousek also reiterated his valuation of the airport, saying he doesn't want to sell it for less than 100 billion koruna ($5.9 billion). As financial institutions face a lack of investment opportunities amid the market turmoil, Prague international airport is "a very safe project for potential investors," he said. In November, the state will name an adviser for the sale of its 100% stake in the airport. The sale will close in 2009, Kalousek added. Some 60 companies, including Aeroports de Paris, a major French airport authority, and Indian infrastructure companies GMR Group and Reliance Airport Developers Ltd., have shown interest. Last year, a record 12.5 million passengers used the airport.

FRANCE

2008-12-19 - **France's La Poste To Get EUR2.7 Billion Capital Injection**
PARIS (Dow Jones)--France's state post office, La Poste, is to get a capital injection of "at least" EUR2.7 billion of state funds as part of a plan to modernize the institution's mail operations, broaden the services it offers and make it more competitive, President Nicolas Sarkozy's office said Friday. La Poste needs to invest a total of EUR6 billion between now and 2012, the statement said, and will change its legal status to that of a limited company. France's state-controlled financial institution Caisse des Depots et Consignations will put up EUR1.5 billion of the capital increase, and the state will contribute the remainder, it said. Legislation ending the monopoly of the French postal sector will be put before Parliament before the summer of next year, the statement added. Labor unions are hostile to the entry of CDC into La Poste's capital, fearing that it could eventually lead to a privatization of the institution. However, a government commission said earlier this week that privatizing La Poste is excluded.

GERMANY

2008-11-05 - **Government: No Deutsche Bahn IPO In Current Legislative Term**
BERLIN (Dow Jones)--The German government has set no new timeframe for the partial privatization of railway operator **Deutsche Bahn AG**, Finance Minister Peer Steinbrueck said Wednesday. "We won't set a time frame,"

Steinbrueck said. Steinbrueck said he would propose "not to budget in any proceeds from an initial public offering of Deutsche Bahn next year." He also said the government "won't commit to any timeframe." At present, the 2009 budget draft envisages around EUR4 billion in total privatization revenue. Speaking at a separate press conference later Wednesday, Transport Minister Wolfgang Tiefensee said the government doesn't plan an IPO of the company in the legislative term ending September 2009, given the difficult economic environment. "The current financial market situation doesn't justify hopes for a partial privatization of DB AG that would generate the proceeds that we urgently need," Tiefensee said. Speaking to reporters, Steinbrueck also said he would oppose paying any bonuses for the company's executives following an IPO. The comments come after it has emerged in recent weeks that the company's executives would have been awarded with millions of euros in bonus payments following the partial privatization, which was called off in October due to unfavorable financial market conditions. Tiefensee has sharply criticized such bonus payments, although he has expressed confidence in Deutsche Bahn Chief Executive Hartmut Mehdorn" Mr. Mehdorn, the whole management board have the backing of the government," Tiefensee said. The government had planned to sell 24.9% of Deutsche Bahn shares in a passenger and freight services subsidiary. A third of the proceeds - expected to run between EUR5 billion and EUR6 billion - would go towards the federal budget.

GREECE

2008-09-17 - **EU Gives "Green Light" To Privatization Of Olympic Airlines**
BRUSSELS (Dow Jones)--The European Commission approved a plan to break up **Olympic Airlines**, Greece's national carrier, and gave a green light to its privatization, the bloc's executive body said Wednesday. "Greece has received the green light from the European Commission to proceed with the privatization," as the Greek plan "does not involve any state aid," the commission said in a statement. The commission also said the last EUR850 million in state aid to the airline were illegal. The European Commission has been pressuring Greece for years to recover hundreds of millions of euros in illegal state subsidies to the carrier and indirectly pushing for the closure of the airline.

HUNGARY

2008-09-01 - **Hungary To Sell Part Of AAK, MVM, Mavir By End-2009**
BUDAPEST (Dow Jones)--Hungary plans to sell stakes in three state-owned firms by the end of next year under a plan to boost retail domestic ownership in nationally owned companies, a government spokesman told state news agency MTI Sunday. Government spokesman David Daroczi told MTI that Hungary plans to sell a minimum 25% minus one-vote stake in highway management company **Allami Autopalya Kezelo Zrt**., or AAK, by May 31; a 75% plus one-vote stake in power wholesaler **Magyar Villamos Muvek Zrt**., or MVM, by Nov. 30; and a stake of between 25% and 50% minus one vote in power grid operator **Mavir Zrt.** by Sept. 30. The companies are also set to be listed on the Budapest Stock Exchange as part of the privatization process. The government plans to spend the proceeds from the sale on paying public debt, Daroczi said. Hungary has privatized nearly all of its state-owned firms over the past 15 years, putting it in the vanguard of foreign direct investment in Central and Eastern Europe.

ITALY

2008-11-23 - **Italy Government Asks Banks To Study Fincantieri Sale Or IPO**
MILAN (Dow Jones)--Italian state holding company Fintecna has asked banks to devise a privatization strategy for cruise ship builder **Fincantieri**, Il Sole 24-Ore writes in its Sunday edition without citing sources. According to Il Sole, the government has sent banks' requests for proposals to "create value" and is considering both a stock market listing and a sale to private investors. Banks including Mediobanca, Credit Suisse Group, Morgan Stanley and Merrill Lynch & Co Inc. are working on the dossier, according to Il Sole. Fincantieri, the world's largest builder of cruise ships, has said it is targeting a 2009 stock market listing which would allow it to raise funds for expansion.

POLAND

2008-07-31 - **Polish Treasury To Sell Over 60% Of Warsaw Stock Exchange**

WARSAW (Dow Jones)--Poland's Treasury Ministry said Thursday it plans to sell more than a 60% stake in the **Warsaw Stock Exchange** in an initial public offer that should see the bourse's first listing Nov.27. In a statement, the ministry said it's increasing the sale from an originally planned 47.8% stake by reserving a *tranche* of privileged, non-voting shares for retail investors. This scheme will allow the Treasury to retain control and block any hostile takeover attempt from WSE's competitors, such as the Wiener Bourse's role in the Budapest Stock Exchange, ministry officials said. "It's an alternative scenario to seeking a strategic investor," Deputy Treasury Minister Michal Chyczewski told a news briefing. Under the new IPO strategy, retail investors will be offered a 25%-35% stake in the exchange in an IPO. Between 30.7% and 35.6% of the Warsaw Stock Exchange will be offered to domestic and foreign institutional investors, including current members of the exchange. All shares offered during the IPO will be so-called silent shares, without voting rights, but with a right to a 2.5 times higher dividend. The details of the dividend policy after privatization will be described in the issuing prospectus. However, the WE will pay at least 40% of its profits as dividend, Treasury Minister Aleksander Grad told reporters. Before the public offer is launched, the exchange will pay out as dividends about 400 million zlotys ($195 million) in excess capital to current shareholders, Grad said. Grad added that in two to three years after the first stage of the WSE's privatization, the treasury will consider "the completion of the privatization process." After the first stage of privatization, assuming 25% of the WSE being sold during the IPO, the treasury will hold 38.25% stake and 51% of voting rights in the WSE.

2008-09-02 - **Polish Treasury Minister: Power Company Energa To Be Sold To Investor**

WARSAW (Dow Jones)--Polish power company **Energa** will likely be sold to a strategic investor rather than floated on the stock exchange, the Dziennik daily reported Treasury Minister Aleksander Grad as saying. The report also quoted Grad as saying that shares in Polish airline LOT SA may not be sold in an initial public offering as planned, but instead sold to an investor. "If the crisis in the airline industry is prolonged, I'm not excluding selling LOT to an investor," Grad told the daily. The minister reiterated the country's 2008 privatization revenue goal of 2.3 billion zloty ($1 billion) and said that in 2009 the Treasury would raise PLN12 billion from privatization.

ROMANIA

2008-09-05 - **Romania Expands Posta Romana Restructuring To 2012**

BUCHAREST (Dow Jones)--The deadline to restructure Romania's state-owned postal company **Posta Romana** ahead of its privatization will be expanded by two years, the Communication Ministry planning to finalize the procedure in 2012, news agency Mediafax reported Friday. The restructuring strategy of the company provides that the restructuring period will take place between 2008 and 2012, prior to the company's privatization. The strategy still needs to be approved by the Government. Posta Romana reported a first-half gross profit of RON79.62 million, higher than the RON27.75 million recorded in the year-earlier period. Romania, through the Communication Ministry, holds a 75% stake in Posta Romana, while investment fund Fondul Proprietatea owns the remainder. The Romanian authorities have postponed several times Posta Romana's privatization over the past few years, arguing that the company needs to be restructured first.

SPAIN

2008-08-01 - **Spanish Government To Sell 30% Stake In Airports Operator AENA**

MADRID (Dow Jones)--The Spanish government is planning to open up the country's airport operator, **AENA**, to private investment, the Spanish Deputy Prime Minister Maria Teresa Fernandez de la Vega said Friday. In a meeting with journalists following the government's weekly cabinet meeting, Fernandez de la Vega said the Spanish government would sell a 30% stake in the country's airport operator to investors, but hold onto a controlling stake. The plan also allows regional governments to participate in the management of the country's top airports, such as Madrid and Barcelona, Fernandez de la Vega said. The stake sale would be for the airport's operations, but not its air traffic control functions, she added.

2008-09-17 - **Madrid Government To Privatize Water Utility**

MADRID (Dow Jones)--The regional government of Madrid plans to sell off 49% of its water utility **Canal Isabel II** on the stock exchange, El Pais newspaper reports Wednesday. "We will give the citizens of Madrid the opportunity to be the owners of their water," Esperanza Aguirre, president of the government of the Madrid region, is quoted as saying. Aguirre says the expected revenue from the part-privatization of Canal Isabel II is needed to pay for EUR4 billion in investments in infrastructure, technology and environmental measures over the next decade. The regional government plans to submit its privatization plan for the utility to the regional Madrid assembly before the end of the year, the newspaper said. Canal Isabel II provides drinking water for almost 6 million people, according to its web site.

SWEDEN

2008-11-04 **Swedish Debt Office Sees Deficit, Asset Sale Halt**

STOCKHOLM (Dow Jones)--Sweden is heading into the red and will halt its privatization drive due to the global financial crisis, the Swedish National Debt Office said Tuesday. "Swedish central government finances are deteriorating," the debt office, or SNDO, said in its latest government borrowing forecast Tuesday. "The current financial crisis is damping economic growth and will make it more difficult to sell state assets. Together this means that the surpluses of recent years are turning into deficits and that central government borrowing is increasing." The SNDO said it has lowered its 2008 Swedish budget surplus forecast to 148 billion Swedish kronor ($19 billion) from its previous forecast in late June of SEK163 billion. In 2009, Sweden will run a SEK23 billion deficit instead of a SEK83 billion surplus, due to lower tax intake from weaker economic activity and ceased state asset sales amid a discouraging global selling environment. Sweden's center right government is looking to sell off SEK200 billion of state assets during its four-year mandate started in September 2006. So far, it has sold SEK95 billion worth, calculates the SNDO, with SEK3 billion coming in next year from the sale of alcohol maker Vin & Sprit earlier this year. The SNDO predicted Tuesday that the SEK3 billion, which is income related to share payments in Vin & Sprit unit Beam Spirits & Wine, will be the only further income from the privatization drive. Officially, the government still has stakes in three companies, including telecommunications company TeliaSonera AB and Nordic financial institution Nordea Bank AB on the selling block. Wholly-owned mortgage company SBAB is the third company up for sale, but is much smaller than the other two companies. The Swedish government and TeliaSonera's board rejected earlier this year a takeover approach from France Telecom SA. With 2009 Swedish gross domestic product forecast at SEK3.266 trillion, according to the debt office, the 2009 deficit is equal to about 0.7% of GDP. Sweden will stay in the red in 2010 too, the final year of the Swedish center-right government's four-year mandate, running a SEK35 billion deficit, the SNDO said Tuesday. The budget projections contrast with the latest Swedish Finance Ministry forecasts from September, when the government foresaw continued budget surpluses through its mandate period. SNDO spokesman Hakan Carlsson said, however, that the government probably put together its forecasts in August, before the crisis gathered pace in September and October, and that it will probably be revising downward its outlook. To deal with the coming deficits, the debt office will increase the amount on offer at regularly scheduled bond auctions every other week to SEK3.5 billion from SEK2 billion currently. Sweden's public finances have been extremely healthy in recent years due to strong economic activity. The SNDO said despite deficits in the next two years, Sweden's total debt will be 33% of GDP in 2009 and 32% in 2010. In 2008, the total is estimated to drop to 35% from about 38% of GDP in 2007, boosted by asset sale income.

UK

2008-12-17 - **UK Junior Minister Quits Over Royal Mail Privatization Plan**

LONDON (Dow Jones)--A ministerial aide has resigned over plans to part privatize **Royal Mail**, saying the proposals "beggared belief," U.K. newspaper the Guardian reports on its Web site Wednesday. Jim McGovern said he was quitting his post as parliamentary private secretary to Pat McFadden, the postal affairs minister, because he thought it was unnecessary for the government to have to resort to the private sector to sort out the problems facing the mail company. McGovern, a former organizer for the GMB union, also said that the plans announced Tuesday by the business secretary, Peter Mandelson, contradicted promises made in Labour's 2005 manifesto.

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